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Supreme Court, U.S.
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No.

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1996

IN RE: SHELDON AND ANITA DROBNY, ***pro se***

On Petition for Writ of Certiorari
To the United States Court of Appeals
For the Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

Petitioners: Sheldon and Anita Drobny, *pro se*
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121 pp

(1a) QUESTION PRESENTED

Whether petitioners were denied due process of law, when the Seventh Circuit:

(1) Covered-up Perjury and Other Illegality by Government Officials,

(2) Refused to Sanction or Even Criticize the *Ex-parte* Communications, Which the Seventh Circuit Actually Itself Practices, and

(3) Refused to Consider Admitted Misrepresentations by Government Attorney During Oral Argument,

particularly where motivated by an apparent desire, however inconsistent with the administration of justice, to protect the government from embarrassment which would result from disclosing, in the opinion or otherwise, documented instances of gross government misconduct?

(1b) PARTIES INVOLVED [(per Rule 21.1(b)]

Sheldon and Anita Drobny were Petitioners in the United States Tax Court and were the Appellants in the United States Court of Appeals for the Seventh Circuit.

The Commissioner of Internal Revenue was the Respondent in the United States Tax Court and is the Appellee in the Court of Appeals for the Seventh Circuit.

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IN THE
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OCTOBER TERM, 1996

IN RE: SHELDON AND ANITA DROBNY, ***pro se***

Petition for Writ of Certiorari to the
United States Court of Appeals
For the Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

Petitioners, Sheldon and Anita Drobny, *pro se* (hereafter, Petitioners, or the Drobnys), pray that a Writ of Certiorari issue reversing the United States Court of Appeals for the Seventh Circuit and to prevent it from denying due process, *i.e.* - requiring that the United States Court of Appeals for the Seventh Circuit order a new trial -

- a fair trial with all relevant evidence and testimony;

- without intimidation or influencing of witnesses;

- without intimidation of trial counsel;

- with a randomly selected trial judge (not one of the government's choosing);

- without ex-parte communications with the trial judge.

Judgment and Opinion Below

On June 5, 1997, the U.S. Court of Appeals for the Seventh Circuit denied the Drobnys' Petition for Rehearing *with Suggestion For* Rehearing *En Banc*. This decision, from which the Drobnys' hereby seek Certiorari, is set out as Appendix A (App. 1). This Decision is not reported. The decision of the United States Court of Appeals for the Seventh Circuit, affirming the Opinion of the United States Tax Court, denying Petitioners' Motion to File a Motion to Set Aside the Judgment (due to the resultant fraud on the trial court), is set out as Appendix B (App. 3) This Decision is not reported.

Jurisdictional Statement

On June 5, 1997, the U.S. Court of Appeals for the Seventh Circuit denied the Drobnys' Petition for Rehearing *with Suggestion For* Rehearing *En Banc*. This decision, from which the Drobnys' hereby seek Certiorari, is set out as Appendix A (App. 1). On May 1, 1997, the United States Court of Appeals for the Seventh Circuit filed its Decision (App. B; App. 3), affirming the judgment of the United States Tax Court. (App. C; App. 33)

Jurisdiction is invoked under 28 U.S.C. § 1254(1) and Rules 10.1, 12.1, and 13.1 of this Court.

Constitutional Provisions

The Fifth Amendment to the United States Constitution provides, in pertinent part:

> "No person shall . . . be deprived of life, liberty or property, without due process of law. . . ."

STATEMENT OF THE CASE

On June 26, 1986, following a trial on the merits, the United States Tax Court entered judgment. On February 18, 1994, after learning of several illegal government and trial court practices, potentially having a significant impact upon the outcome of the case, Petitioners filed a Motion to File a Motion to Set Aside the Judgment, due to the resultant fraud on the trial court, including the following practices:

Intimidating and influencing witnesses;

Intimidating trial counsel;

Perjury and other abuses of process and illegality perpetrated by government officials;

Making secret settlement offers directly to other petitioners (without the knowledge or consent of trial counsel), with special inducements to fire trial counsel;

Secret *Ex-parte* communications with United States Tax Court Judge Simpson, inducing him to become the trial judge;

Crafting and cultivating a Fifth Amendment exercise by a key witness (the attorney upon whom the Drobnys relied, thus effectively depriving them of their defense - their reliance on counsel), in order to deprive the Drobnys of the testimony, their defense, and to further prejudice other witnesses and the trial judge.

Reasons for Granting the Writ

Petitioners - Appellants, Sheldon and Anita Drobny, respectfully request that this Honorable Court issue a Writ of Certiorari to the Court of Appeals for the Seventh Circuit, in a case involving "fraud on the court," in a Tax Court case, in light of most exceptional circumstances, as follows, relative to the Seventh Circuit's:

(1) refusal to even mention, and thus covering-up of perjury and other abuses of process and illegality perpetrated by government officials,

(2) refusal to sanction or even criticize the prohibited practice of *ex-parte* communications, which practice is not only encouraged (at least in practice) by the Seventh Circuit, but the Seventh Circuit actually regularly engages in the practice of *ex-parte* or *extrajudicial* communications, and

(3) ruling, expressly refusing to even consider, the admittedly false statement by government appellate attorney Janet Bradley during oral argument.[1]

This case features clearly documented and indisputable government abuse, albeit not particularly evident from the Seventh Circuit's opinion, which covers up the resultant fraud on the court. As a consequence of the Seventh Circuit's cover-up, and refusal to even mention, let alone address the attendant exceptional circumstances, adequate relief cannot be attained in any other form or from any other court. Consequently, the exceptional circumstances warrant the grant of the Writ and will be in aid of the exercise of this Honorable Court's appellate jurisdiction. Relief is unavailable from any other court.

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[1] On July 16, 1996, by Federal Express, Mr. Gary R. Allen, Chief Appellate Section, U.S. Department of Justice, wrote to Thomas F. Strubbe, Esquire, Clerk, U.S. Court of Appeals for the Seventh Circuit, admitting that in response to a question posed by the justices during oral argument, the assertion made by Janet Bradley was "a misleading statement concerning the degree to which Harmon Dow [the assistant District Counsel Attorney who initiated the secret *ex parte* communications with the trial court judge and who thus facilitated the assignment of the case to the trial court judge, of his own choosing] was, despite Janet Bradley's contrary assertions, substantially involved in [the] underlying Tax Court case."

ARGUMENT

I. **Seventh Circuit's cover-up of perjury and other abuses and illegality perpetrated by government officials, including IRS Agent Feinglass's *Admitted Transgressions* into the Attorney-Client Relationship, at the Direction of Government Trial Counsel.**

On January 18, 1985, IRS Inspectors Peter McCauley and Jon Corcoran interviewed IRS Agent Irving Feinglass, in the presence of N.T.E.U. representative Charles Turek. Feinglass admitted, under oath, that:

> [p]rior to the trial [of tax shelters involving research and development of the Aloe Vera products], Revenue Agent FEINGLASS told one of the investors, BENJAMIN ROSENBERG, that the I.R.S. would accept a cash settlement from him but only if he supplied the I.R.S. with information and discharge RANDALL GOULDING [counsel of record to most of the petitioners] as his attorney." Irving Feinglass stated that "[t]his was done per the instructions of I.R.S. legal council [sic], LOREN GORE and BILL SABIN. (Jt. Ex. 249; App. E, App. 83)

Such a clear government transgression into the attorney-client relationship and illegal intimidation tactic perpetrated against the attorney of record (Goulding) is intolerable. Yet, sadly, this critical document, attached hereto as Appendix E, App. 82[2], establishing conclusive, gross government misconduct and tending to establish the requisite fraud on the court, was ignored and not even mentioned in the Seventh Circuit's opinion. Perhaps even more sadly, far from being outraged by such blatant government illegality, the Seventh Circuit covered up this heavy-handed fraudulent conduct. In furtherance of the fraud, the Seventh Circuit falsely suggested that the evidence was tenuous, ignoring that the allegation was supported by hard documentary evidence:

> The Drobnys also *assert* that prior to the trial, IRS Agent Feinglass "frightened [Benjamin] Rosenberg into not testifying" by telling him that the IRS would only agree to settle his case if he agreed (1) to testify that the aloe vera tax shelters were shams, and (2) to fire his attorney, Randall Goulding. (App. 23)

The Seventh Circuit then falsely states (App. 30) that:

> . . . The *allegation* does not rest on direct testimony in the record, but upon Sheldon Drobnys' hearsay testimony."

Far from being a mere "*assert[ion],*" far from being a mere *allegation,* and far from being based merely "upon Sheldon Drobnys' hearsay testimony," and far from "*allegedly* occurr[ing]" (at App. 11):

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[2] Nor was there ever any question as to the authenticity of this document. Despite the government's repeatedly denials of misconduct (as well as Seventh Circuit denials), this document (wherein Feinglass admitted, under oath, to his surreptitious contacts of Goulding's clients with special inducements to fire Goulding as their lawyer), App. E, App. 82, was *filed by the government* in its own motion.

> Appendix E is hard, indisputable, and undisputed, documentary evidence - a statement against the pecuniary interest of the IRS which produced the document.

Certainly, it is no coincidence that the Seventh Circuit took an equally protectionist attitude (covering up this and other evidence of blatantly outrageous government misconduct)[3] on behalf of the government, in the case of *Goulding v. United States*, 26 F.3d 656 (7th Cir. 1994)[4]. Despite the existence of the same document in that case, the Seventh Circuit's Opinions covered-up there to, concluding (based on contrary affidavits and correspondence submitted by government agents, albeit clearly false), that the government agents engaged in no wrongful, illegal or other misconduct. By ignoring this documentary evidence, the Seventh Circuit held that Goulding:

> failed to demonstrate how his rights under the First Amendment have been infringed. . . . Our reading of the . . . record convinces us that the agents and their supervisor *were merely fulfilling their duties*. . . . and that Goulding's claims rest on

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[3] Such protection and insulation is extended by the Seventh Circuit only to the government; among the disparate treatment is that this courtesy is never extended to those in litigation with the government.

[4] Briefly, Goulding's litigation with the IRS complained of the surreptitious and disparaging contacts of Goulding's clients by Agents Feinglass and Dietz. Following Goulding's complaints to the IRS District Director came retaliation by Agents Feinglass and Dietz. Goulding countered with a civil rights suit, prompting more IRS retaliation, this time a criminal investigation of Goulding and his clients, all instigated by Agents Feinglass and/or Dietz. **Against this history of IRS retaliation protected by Seventh Circuit cover-up - the Drobnys persist.**

> little more than the fact that the criminal investigation was started sometime after he brought suit against the IRS agents and *only meager evidence that those agents disliked him.* Given the *flimsiness*[5] *of his claims*, the district court was completely within its authority when it denied Goulding's motions to dismiss the prosecution. . . . We held that Goulding failed to demonstrate that the government acted selectively or vindictively in its actions. *Goulding v. Feinglass*, 811 F.2d 1099, 1104 (7th Cir.), *cert. denied*, 482 U.S. 929 (1987).

These conclusions, upon which the respective outcomes in Goulding's litigation with the government were premised, are not rationally reconcilable with the facts, facts which the government always knew, and facts which the Seventh Circuit knew but refused to acknowledge and reported otherwise. Moreover, the testimony of the various government officials in this case is not reconcilable;

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[5] In addition to Agent Feinglass's admitted offer to Goulding's clients conditioned on the client firing Goulding, Goulding submitted numerous third party affidavits, including that Feinglass told one client: "You ought to shoot Goulding"; telling other clients that an audit was "a result of Goulding's activities"; to an attorney: "I won't [allow] more than fifty percent ... since it's a Goulding deal. All Goulding deals are flaky. You should see how flaky his other deals are." To another client: "If I were you, I wouldn't have Goulding representing me." To a business associate: "I don't know how he (Goulding) sleeps at night." Shortly after Goulding's complaint to the IRS District Director, Agent Dietz notified Goulding that Dietz would audit every partnership ever formed by Goulding. Dietz also repeatedly ignored validly executed Powers of Attorney, which authorized Goulding to act on behalf of clients before the IRS. Such consequent inability to represent clients before the IRS forced Goulding from practice before the IRS.

some government officials are clearly still fabricating. And such perjury can only rationally be ascribed to a cover-up.[6] Although, of course not mentioned in the Seventh Circuit's opinion, even the trial court judge acknowledged the inconsistencies in the various statements by Feinglass, all under oath.[7] In refusing to reveal the facts, and thus keeping these facts from its various opinions (and even falsely reporting facts embarrassing to the government), the Seventh Circuit has effectively conspired with the government. The Seventh Circuit has made a farce of the judicial and administrative process. It sends a clear and unequivocal signal to IRS Agents that the Seventh Circuit will back and will not enforce the law against IRS's retaliatory actions and other government misconduct.

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[6] Mr. Robert Ratchford, the IRS attorney originally assigned this case, requested and received sworn affidavits from Sabin and Gore that they did not instruct Feinglass to engage in the above conduct. Upon discovering Feinglass's conflicting testimony - the January 1985 inspector's report (App. E, App. 83), that he acted "per the instructions ... of ... Gore and ... Sabin," Mr. Ratchford refused to bury the document. Instead, obviously fearing more cover-up, without the knowledge of his supervisor, he referred the case to the Treasury Department Inspector General's Office, and courageously exposed this government fraud and cover-up; he filed the document with the court. Unfortunately, once Ratchford was out of the picture, the scope of the government's inspection was limited to asking Sabin, Gore and Feinglass whether they did anything wrong. Feinglass denied what he said in 1985 and Gore and Sabin denied they directed Feinglass. Case closed, everyone exonerated! Not one other witnesses was contacted; no other evidence was secured, for this "investigation."

[7] The multiplicity of internal investigations was occasioned by the discovery of these improprieties and the courageous refusal of original IRS District Counsel Ratchford to cover up some of some of the now-disclosed transgressions. The matter was transferred to Cincinnati District Counsel which then squelched the matter and refused to voluntarily provide any further discovery.

Both Loren Gore and Bill Sabin denied giving these "instructions" which IRS Agent Feinglass claimed to have followed. TR 415-416, 437-438[8], 480-481. Loren Gore's denial was despite not only Revenue Agent Feinglass's testimony, but it further contradicted the testimony of her former colleague[9], Francis Emmons. As correctly noted by the Seventh Circuit (footnote 23, at App. 29), in the 1994 hearing on the motion to file the motion to vacate, the Drobnys attempted to introduce the testimony of Francis Emmons[10]. Mr. Emmons was retained by Goulding due to Goulding's conflict of interest engendered by the outrageous conditions placed upon the settlement offer made by IRS District

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[8] At the hearing, Ms. Gore was asked, Did you ever suggest [that settlement of cases would require that] Mr. Randy Goulding withdraw his entry of appearance? She responded, "No," and then immediately qualified, "*To the best of my recollection*, No." (TR 437-438.)

[9] Contrary to the Seventh Circuit's Opinion (in footnote 23, at App. 29) Loren Gore was not the "one of Feinglass's colleagues," she was the colleague of the witness, Mr. Emmons, himself.

[10] Besides mischaracterizing the relationship between Emmons and Gore, the Seventh Circuit further mischaracterized Emmons as "an investor in a *different* tax shelter [and that he was] represented by Goulding." (footnote 23, at App. 29) So characterized, he would have had a vested interest in the case's outcome. By contrast, however, Emmons had previously worked with Gore, and Gore had specifically required that Goulding hire Emmons, as a condition for Goulding's clients to have the settlement. Thus, while the Seventh Circuit falsely casted aspersions on the credibility of this testimony, the relationship of Emmons and Gore, as former fellow employees and colleagues, makes the trustworthiness far more credible as against the government than it would have been with the Seventh Circuit's mischaracterization of Emmons as "an investor," "as Goulding's client" and that Gore was "one of Feinglass's colleagues."

Counsel Attorney Loren Gore and to accommodate Ms. Gore's express condition of the settlement. Loren Gore made settlement offers to Goulding's clients (on some occasions without Goulding's knowledge), also conditioned on such clients firing Goulding. Despite Ms. Gore's equivocal denial (such denial being hedged, "... *To the best of [her] recollection* ..." (TR 437-438)), the identical settlement offers which she accepted from clients who had just fired Goulding, she expressly rejected when proposed by Goulding on behalf of clients whom he still represented. (TR 440-442, 508; Pet Ex 264-265) Mr. Emmons' testimony, excluded by the trial court, was necessary to show the pattern of this outrageous practice perpetrated against trial counsel (Goulding). And contrary to the testimony of Loren Gore and Bill Sabin, this intimidating practice was not merely the isolated frolic of IRS Agent Feinglass (which would be outrageous enough), but, as attested to by Agent Feinglass and Mr. Emmons (and supported by strong circumstantial evidence (Pet Ex 264-265)), was also practiced by these IRS District Counsel Attorneys.

Effectively, it was not enough that the IRS controlled the selection of the trial judge; it also wanted to assure that the right opposing counsel was engaged.

II. **The Seventh Circuit's own practice of *ex-parte* or *extrajudicial* communications may explain its refusal to sanction or even criticize the Government's practice of *ex-parte* communications.**

Curiously, and perhaps furnishing some insight as to why the Seventh Circuit refuses to sanction the practice of *ex-parte* or *extrajudicial* communications - the Seventh Circuit itself apparently regularly engages in the practice. Before Mr. Drobny, a non-attorney, was aware of the impropriety of *ex-parte* or *extrajudicial* communications, on or about May 26, 1994, in an unrelated case, *Goulding v. United States*, 26 F.3d 656 (7th Cir.

1994), he attempted to contact the clerk of court for the Seventh Circuit, having learned of the issuance of the opinion in that case, and being personally aware of numerous inexplicable factual inaccuracies within the opinion. Seeking information as to how to bring these inaccuracies to the court's attention, he telephoned Justice Cummings' clerk. However, Justice Cummings and not his clerk, answered the telephone. Justice Cummings proceeded to discuss with Mr. Drobny this new government disclosure (App. F, App. 85) and the consequent inaccuracies of the Seventh Circuit's opinion. Justice Cummings then requested a copy of this document and corresponded with Mr. Drobny.[11] Justice Cummings recontacted Drobny, requesting any additional information in his possession. Mr. Drobny complied, forwarding to him such information (see Appendix F, App. 85, evidencing these communications). No record was ever made of these third-party contacts or of any others by the Appellate Court.

III. **The Seventh Circuit's ruling, expressly refused to even consider the truth regarding the *admittedly false statement* by government appellate attorney Janet Bradley during oral argument.**

During oral argument before the Seventh Circuit, government appellate attorney Janet Bradley, in an attempt to minimize the significance of Harmon Dow's *ex parte* communication with the trial judge, misrepresented the degree of his involvement and participation in the trial. Mr. Dow had appeared and substantially participated in the trial.

The Drobnys provided to the Seventh Circuit an exact excerpted transcript of the misleading statement attached as Appendix G, App. 89[12]. Janet Bradley falsely told the Seventh Circuit:

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[11] Unbeknownst to Drobny, the same court had already taken judicial notice of this document pursuant to a motion filed by one of the *amici curiae*, in that case.

> *I'm sure* [Mr. Dow] has no idea of the facts of the large volume of cases there - it's basically the lower line attorneys, like myself, who are the ones that actually write the briefs, argue the cases, and deal with the other side in the courts in handling the matters. So that was the status of what happened there. There was no allegation of anything more than that and there was no evidence whatsoever of anything more than that.

On July 8, 1996, as soon as practicable following the Drobnys' receipt of the audio tape of the oral arguments, and upon noting a significant misrepresentation during oral argument by government attorney Janet Bradley, the Drobnys filed a Motion to Supplement the Oral Arguments due to such false statements. On July 16, 1996, by Federal Express, Mr. Gary R. Allen, Chief Appellate Section, U.S. Department of Justice, wrote to Thomas F. Strubbe, Esquire, Clerk, U.S. Court of Appeals for the Seventh Circuit, admitting that the assertion made by Janet Bradley during oral argument, was "a misleading statement concerning the degree to which Harmon Dow was involved in [the] underlying Tax Court case."

During oral arguments, the panel specifically inquired into this matter - Harmon Dow's trial involvement and participation.

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[12] On July 1, 1996, the Drobnys received from the Seventh Circuit, the audio tape of the oral arguments. The Drobnys had no opportunity during oral argument to rebut Ms. Bradley's false and misleading assertion, given the time constraints coupled with the fact that the Drobnys had exhausted their ten minute time allotment, leaving no time for rebuttal.

Significantly, Mr. Dow made the *ex parte* communication with the trial judge, of which Appellants complained, as one of the numerous elements set forth in their Motion to File a Motion to Set Aside the Judgment[13] due to the resultant fraud on the trial court.

On July 16, 1996, this Court denied Appellants' Motion to Supplement the Oral Arguments. The Drobnys then urged the Seventh Circuit to reconsider its ruling on the motion and to consider the Appellee's own admission as to the falsity of Janet Bradley assertions during oral argument. Yet, on August 5, 1996, the Seventh Circuit denied this motion too, thus refusing to consider that above statements by government attorney Janet Bradley were false. The decision of the Seventh Circuit to ignore the admittedly false representations by the government's appellate counsel during oral arguments, was arbitrary and capricious.

IV. **The Government's Attorneys and Agents Committed Fraud upon the Court in Connection with the 1984 Trial. The 1986 Decision Must, in All Fairness, Be Vacated.**

The hearing on the Drobnys' motion to file a motion to reopen, revealed the following government improprieties/ irregularities (including witness intimidation, suborning of perjury, transgression into the attorney-client relationship, illegal intimidation tactics directed at an attorney of record (Goulding), attempting to prejudice the trial judge through *ex parte* communications, and manipulating the judicial selection process in order to secure for the trial, the judge of its selection):

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[13] The Seventh Circuit misconstrued the nature of the proceeding (in footnote 23, at App. 29), the trial court never permitted the filing of the motion to vacate. The hearing was only to determine whether Drobny could file the motion, or even have discovery.

1. On December 16, 1982, IRS Agents Feinglass and Rosen offered the Drobnys a civil settlement based on "cash invested" with no penalties, adding that they better accept.

2. By January 12, 1983, the Drobnys had not accepted; on that date, the agents referred the case for criminal investigation of the Drobnys.[14]

3. Supervisory district counsel attorney, Harmon Dow, contacted the Judge Simpson, *ex parte*, without petitioners' trial counsels' knowledge, consent or participation. As a consequence of the *ex parte* contact, Judge Simpson became the trial judge.[15] During this *ex parte* communication, Dow also characterized the program as a "tax shelter."

4. Prior to trial, Revenue Agent Irving Feinglass intimidated witnesses, admittedly contacting at least one petitioner, Benjamin Rosenberg and discussed settlement, without the knowledge or consent of Rosenberg's trial counsel (Goulding), all "per the instructions of IRS [trial counsel, government attorneys] Loren Gore and Bill Sabin."

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[14] Significancy, nothing happened between December 16, 1982 and January 12, 1983. Certainly, in this one month, nothing could justify a criminal investigation. The only rational explanation is a retaliatory use (the Drobnys not having accepted the IRS Agents' demands for civil settlement) of the IRS power to instigate the dreaded criminal investigation. Nor has the IRS claimed otherwise.

[15] Similar to its established practice of not addressing other embarrassing matters of government misconduct, the Seventh Circuit never mentioned or dealt with the fact that the government's selecting the trial judge of its choice.

5. On April 30, 1984, Harmon Dow announced in open court, and in the presence of key witnesses who were subpoenaed, the pending "criminal investigation of Drobny."

6. Mr. Sabin intimidated the single most important witness in the case, Attorney Marvin Kamensky, upon whom and upon whose legal opinion Mr. Drobny relied. Sabin caused Mr. Kamensky, out of fear of prosecution (the thinly veiled threat of which was never pursued), to assert his Fifth Amendment right and thus not testify. This was accomplished in a surreptitious, eleventh-hour, night before his testimony contact of Kamensky. This contact occurred after the trial had started, even though the government did not anticipate calling Kamensky as a witness. This contact also followed a discussion between Sabin and his supervisor, Dow, regarding the consequences of Kamensky's assertion of his Fifth Amendment right to not testify. While the Drobnys anticipated calling him only as a rebuttal witness, these tactics foreclosed Kamensky's testimony and cultivated a frenzied court atmosphere, further prejudicing witnesses and the judge.

7. In that telephone conference, Sabin told Kamensky that if he, Kamensky, did not testify as the government believed he should testify, the IRS could open a case against him and charge him with perjury[16]. (TR 58-60) Sabin also told Kamensky that he could give Kamensky no assurances that he was not a target of any investigations. (TR 495) Yet, at the time of his conversation with Kamensky, Sabin knew that Kamensky was not under any criminal investigation, knew that Kamensky was not the target of any investigation, and that none was imminent. (TR 518-19) Indeed, prior to his conversation with Kamensky, Sabin learned from Deputy Director Harold Cook, that Kamensky was not the

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[16] Sabin specifically denied using the term "perjury."

subject of any criminal investigation. (TR 518-19, 522) Also, immediately prior to his conversation with Kamensky, Sabin had a specific discussion with Harmon Dow concerning the effect, if at trial, Kamensky were to assert his Fifth Amendment privilege.[17] (TR 273-74)

8. As a result of Sabin's contact of him the night before his contemplated testimony, Kamensky was "more frightened after that phone call than I can ever remember being frightened in my life." (TR 60) Heightening the anxiety for Kamensky, Sabin provided Mark Samotny (a former employee of Kamensky), by contrast, with a letter assuring Samotny that he was not a target of any criminal investigation. These circumstances, cultivated by government agents, prompted Kamensky's assertion of his Fifth Amendment right to not testify. (TR 58-62, 486-89, 490-91, 494-96) But for such circumstances so cultivated by the government, Marvin Kamensky would not have taken the Fifth Amendment and would have testified for the Drobnys. (TR 61)[18] Perhaps even more significant, the Fifth Amendment assertion, no doubt, colored the judge's perception of the case.[19]

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[17] Apparently, the threat of criminal proceedings to affect a civil advantage is pervasively employed by the government. In this case, it was used to intimidate Kamensky to assure that he would not testify; it was used to facilitate an open-court Fifth Amendment assertion, to create the appearance of "guilt"; and it was used by IRS Agents to deter the Drobnys from litigating. Each use was illegal.

[18] This was the *sine qua non* of the deprivation of Mr. Kamensky's testimony, and thus a vital witness.

[19] The government, in pursuit of maximizing the impact of this devious ploy, argued, on brief, that Kamensky's Fifth Amendment assertion (albeit manipulated by the government's own foul play), evidenced the Drobnys' fraud.

Any one of these improprieties alone, constitutes a fraud on the court, and thus suffices to permit the Drobnys discovery or a new trial. But cumulatively, these indiscretions cannot be ascribed to mere mistake or inadvertence. And cumulatively, these indiscretions are so egregious that for a court to tolerate and thus condone such improprieties is to aid and give countenance and judicial approval to same and make a mockery out of the entire judicial process. Collectively, these acts render the entire proceeding a sham and a nullity.

It was a violation of the Drobnys' federally guaranteed constitutional rights to deprive them of the exonerative testimony of Marvin Kamensky - whose testimony made out the "reliance on counsel" defense. Without the testimony of this witness, all there was in support of the Drobnys' position - which was an absolute and complete defense against the fraud penalty - was Mr. Drobnys' own testimony. The prejudicial effect was maximized through the negative implications of the manipulated Fifth Amendment assertion by Kamensky, to whom the Seventh Circuit refers as Mr. "Drobny's partner in crime." (App. 28) It was also error to deny the Drobnys the testimony of Ben Rosenberg.

The due process, constitutional right to present evidence on one's own behalf is not limited to criminal cases. The Drobnys have a due process right to present relevant evidence to be considered by the fact finder. See *Goldberg v. Kelly*, 397 U.S. 254, 25 L.Ed.2d 287 (1970).

What more can possibly be required in order to find sufficient government improprieties/ irregularities for "fraud on the court?" How much more perversion of the process is tolerable before due process is deemed denied and the public's confidence in the judicial system is undermined? Is the government to be permitted such an intolerable degree of illegal conduct (far exceeding that which would ever be tolerated from any private litigant), with total impunity?

In addition,

9. During oral argument before the Seventh Circuit, government appellate attorney Janet Bradley, misrepresented the degree of Harmon Dow's involvement and participation in the trial, in an attempt to minimize the significance of Harmon Dow's *ex parte* communication with the trial judge. Yet, despite the government's admission of the falsity, the Seventh Circuit has expressly refused to even consider the truth.

The sole question in this case is whether the pattern of abuse here uncovered rises to such levels as to require, to comply with due process, a reopening or at least discovery to the victims (petitioners - appellants, herein) of such government misconduct, to investigate the degree of abuse perpetrated and the effect on the trial, and thus to ascertain whether the resulting government fraud was sufficient to deny the Drobnys due process and thus to require a new trial.

Unfortunately, the Tax Court, following the hearing, took a protectionist attitude, which was apparently adopted by the Seventh Circuit as to such sensitive matters of government misconduct. Such a brazen disregard for, and undermining of, due process should not be covered-up or ignored. With the massive, institutionalized government abuse, perpetrated by numerous government officials, in concert, collectively constituting a fraud on the trial court, it was hardly ironic, that during oral argument, the government attorney made a significant misrepresentation.

By controlling: (1) the evidence, (2) the selection of the trial judge, (3) the witnesses who would testify and who would not testify, and even (4) who would act as opposing counsel, the government assured that any resemblance of the proceeding to a "trial," with due process, was pure coincidence. As a result of the government's frauds, the 1986 decision is a *nullity*.[20] The 1986 decision should have been vacated, and a fair trial, with all of the evidence, before a randomly selected judge, should be ordered.

In the words of Mr. Justice Clark, speaking for a majority of the Supreme Court in *Mapp v. Ohio*, 367 U.S. 643, 6 L.Ed.2d 1081 (1961):

> "There are those who say, as did Justice (then Judge) Cardozo, that under our constitutional exclusionary doctrine '[t]he criminal is to go free because the constable has blundered.' *People v. Defore*, 242 NY [12], at 21, 150 NE [585], at 587 [(1926)]. In some cases this will undoubtedly be the result. But, as was said in *Elkins [v. United States*, 364 U.S. 206, 4 L.Ed.2d 1669 (1960)], '*there is another consideration--the imperative of judicial integrity*.' 364 US, at 222. [Emphasis added.] The criminal goes free, if he must, but it is the law that sets him free. *Nothing can destroy a government more quickly than its failure to observe its own laws, or worse, its disregard of the charter of its own existence*. As Mr. Justice Brandeis, dissenting, said in *Olmstead v United States*, 277 U.S. 438, 485, 72 L Ed 944, 959 . . .

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[20] If the 1986 decision is a nullity, it matters not that it took so many years to discover the government's agent's frauds. While the Seventh Circuit suggests otherwise, most of the government atrocities the Seventh Circuit were not known until just before the filing of the subject motion. Additionally, as a practical matter, it was foolhardy if not impossible to be a "whistle blower," during the frenzy and overzealous activities experienced from the IRS attorneys and agents during their tax shelter audits. Only Randall Goulding was foolhardy enough to speak out against the government abuse, and we see what happened to him.

> (1928): '*Our Government is the potent, the omnipresent teacher. For good or for ill, it teaches the whole people by its example. . . . IF THE GOVERNMENT BECOMES A LAWBREAKER; IT BREEDS CONTEMPT FOR LAW; IT INVITES EVERY MAN TO BECOME A LAW UNTO HIMSELF; IT INVITES ANARCHY*.'" *Mapp v. Ohio*, *supra*, 367 U.S. at 659, 6 L.Ed.2d at 1092. (Emphasis added.)

In evaluating the merits of the issues raised on appeal, we beseech Your Honors to keep an open mind to the harsh realities of life, including that government officials, in all their zeal, sometimes lie and break the very laws which they are sworn to uphold, as here they clearly have.[21]

The "appearance of justice" cries out against upholding a judgment against a citizen obtained by official threats, whether such threats are subtle or otherwise, that keep witnesses off the stand, whose testimony reasonably could have altered the outcome in the citizen's favor.

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[21] E.g., from judicial decisions such as *United States v. Cortina*, 630 F.2d 1207 (7 Cir. 1980) (affirming a District Court's ruling resting on outright disbelief of a federal law enforcement officer); *United States v. Freymuller*, 571 F.Supp. 61, 67 (N.D. Ill. 1983) (District Judge Grady, disbelieving police officers in allowing a motion to suppress); the infamous *El Rukn* cases - *United States v. Boyd, et al.*, No. 89 CR 908, N.D. Ill., E.D., Sept. 21, 1993, and *United States v. Burnside, et al.*, No. 89 CR 909, N.D. Ill., E.D., June 4, 1993; and from the recent national news: the apparent perjury [and demonstration of past illegal evidence planting by Mark Fuhrman, including in the O.J. Simpson trial]; the recent proof (not speculation, but proof) of the Philadelphia police department, leading to judicial remedies for injured parties; the Waco hearings; hearings into the Ruby Ridge incident and the Orlando Cruz incident, which resulted in numerous indictments of public officials, including sitting judges.

The Supreme Court has emphasized that one of the most important functions of the judicial system is to make plain to litigants and society at large that justice is done in our courts. See *Offutt v. United States*, 348 U.S. 11, 14, 99 L.Ed. 11 (1954) ("Justice must satisfy the appearance of justice."); *Adams v. United States ex rel McCann*, 317 U.S. 269, 63 S.Ct. 236, 87 L.Ed. 268 (1942) ("The public conscience must be satisfied that fairness dominates the administration of justice.") It is no doubt the wisdom of such an approach, "satisfy[ing] the appearance of justice," which seeks to avoid such atrocities as the Oklahoma City bombing.

CONCLUSION

In the interest of full, open and honest government, we urge that this Court issue a Writ of Certiorari to the Court of Appeals for the Seventh Circuit, reversing its decisions below, and requiring that the trial court and the Court of Appeals for the Seventh Circuit consider all the evidence, all government misrepresentations, including those to which the government's appellate counsel has admitted; in the interest of fairness, particularly given the clearly illegal government conduct in the underlying case, the Drobnys should be given the opportunity to prove "fraud on the court" in a similar fashion as the government proves taxpayer fraud.

The abundance of circumstantial evidence and contradictory statements, suffice to find perjury and fraud. This Court should logically pierce the veil of this deceit to protect the integrity of the judicial system. The wrongful conduct was adequately demonstrated to illustrate sufficient *smoke* to evidence *fire* which cannot be proved or disproved without additional discovery. The Drobnys demonstrated at least sufficient *smoke* to have satisfied their burden in order to have a reopening and some inquiry in order to file a motion to vacate the decision.

Respectfully submitted,

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APPENDICES

United States Court of Appeals
For the Seventh Circuit
Chicago, Illinois 60604

June 5, 1997.

Before

Hon. JOHN L. COFFEY, Circuit Judge

Hon. DANIEL A. MANION, Circuit Judge

Hon. MICHAEL S. KANNE, Circuit Judge

SHELDON DROBNY and ANITA DROBNY, Petitioners-Appellants,	Appeal from the United States Tax Court
No. 95-2966 v.	No. 16985-83
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	Mary Ann Cohen, Chief Judge.

ORDER

On consideration of the petition for rehearing and suggestion for rehearing en banc filed in the above-entitled cause by appellants

Sheldon Drobny and Anita Drobny, no judge in active service has requested a vote thereon, and all of the judges on the original panel have voted to deny a rehearing. Accordingly,

IT IS ORDERED that the aforesaid petition for rehearing with suggestion for rehearing en banc is DENIED.

No. 95-2966

SHELDON DROBNY and ANITA DROBNY,

Petitioners-Appellants,

V.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the Order of the United States Tax Court

No. 16985-83-**Mary Ann Cohen,** *Chief Judge.*

ARGUED JUNE 5, 1996-DECIDED MAY 1, 1997

Before COFFEY, MANION and KANNE, *Circuit Judges.*

COFFEY, Circuit Judge. The petitioners-appellants, Sheldon and Anita Drobny, are husband and wife. During the late 1970's, Sheldon Drobny, a former IRS agent, was a partner in the accounting firm of Adler & Drobny, Ltd., based near Chicago, Illinois. Drobny promoted (and he and his wife invested in) two "research and development" programs purportedly designed to develop the substance known as "aloe vera" for commercial purposes. "Aloe vera" is an extract of the *Aloe Barbadensis* plant, and today is used in many skin-care and personal hygiene products.

The Drobnys, on their joint federal income tax return for 1979 (prepared by Sheldon Drobny), claimed certain losses as deductions in connection with their investment in the aloe vera research and development programs. In 1983, the Illinois District Director of the IRS (based in Chicago, Illinois) disallowed these deductions, after determining through investigation that they were part of an impermissible "tax shelter" scheme, and informed the Drobnys that they were liable for a $10,877 tax deficiency. The District Director also notified Sheldon Drobny that he was liable for a civil fraud penalty (or "addition to tax") in the amount of $5,439. The Drobnys petitioned the Tax Court for a redetermination of the deficiency and the addition to tax. Following a trial, the United States Tax Court ruled in favor of the Commissioner. *Drobny v. C.I.R.*, 86 T.C. 1326 (1986) *("Drobny I").* The Drobnys failed to file a timely notice of appeal[1] or a timely motion to vacate or revise the decision, which became final on September 24, 1986 (90 days after the decision was entered). Fed.R. App.P. 13(a); 26 U.S.C. § 7481(a)(1). In February of 1994, more than seven years after the decision became final, the Drobnys filed a motion to vacate the 1986 decision in *Drobny I,* arguing that the Tax Court should set aside its previous decision because the Commissioner, through his agents and attorneys,[2] had allegedly engaged in conduct that amounted to a "fraud upon the court." After a lengthy hearing, the Tax Court found that the petitioners had fallen short of demonstrating a "fraud upon the court" that would warrant vacating an otherwise final decision and denied the motion on May 17, 1995. *Drobny v. C.I.R.*, 69 T.C.M.

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[1] The petitioners filed an untimely appeal with this court on September 25, 1986, one day after the 90-day period specified by Fed.R.App.P. 13(a), and subsequently riled a motion to dismiss the appeal, which the court granted October 29, 1986.

[2] When the petitioners refer to the Commissioner's "agents and attorneys," they are referring, respectively, to the Office of the District Director for the Illinois District (e.g., Agents Rosen and Feinglass) and the Office of the District Counsel for the Illinois District (e.g., Assistant District Counsel Dow and Attorney Sabin).

(CCH) 2600 *("Drobny II").* We affirm.

I. BACKGROUND

Petitioner Sheldon Drobny, a Certified Public Accountant, worked for the Internal Revenue Service ("IRS") from 1967 until 1971, when he entered the private practice of accounting in the Chicago, Illinois area. During the 1970's, Drobny began to promote tax shelters, often working closely with a Chicago attorney named Marvin Kamensky, who specialized in the formation of research and development tax shelters.

In November of 1979, Kamensky and one of his associates, Marc Z. Samotny, came to Drobny to enlist his support in the promotion of two enterprises (a partnership and a joint venture) that were ostensibly designed to develop products based on the substance aloe vera.[3] These alleged business enterprises are referred to in the briefs and in case law as "tax shelters," for they were structured to take advantage of the tax laws by allowing the investor to deduct his proportional share of losses incurred by the program (e.g., money devoted to research and development) on his personal income tax return. The higher the income-tax bracket of the investor, the greater the value of the deduction.[4] Kamensky and Samotny, the tax attorneys, persuaded Drobny, the certified public accountant, to solicit his clients and associates who might be interested in participating in the aloe vera tax shelters as investors. Drobny agreed, and was listed in the offering materials as a promoter and referred to as a member of an accounting firm that specialized in financial and tax consultation. Drobny and his wife, petitioner-appellant Anita Drobny, also *became* investors in the two programs, along with 21 others. On their joint income tax return for 1979, the Drobnys deducted approximately $28,000 as their *pro rata* share of "research and development" losses incurred by the two *aloe vera* programs.[5]

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[3] These programs sought to take advantage of the growing interest in the alleged medicinal properties of aloe vera. The partnership, known as AloEase Partnership, was formed to develop and market an aloe-vera-based eye care product (similar to Visine or Murine). The joint venture, Farm Animal Product Venture, was formed to develop and market "Pork Pardner," a medicine to be fed to farm animals, particularly *hogs, for the* prevention and treatment of various diseases that decrease the size of litters and adversely affect the health of small pigs." *Drobny* I, 86 T.C. at 1328. The partnership and the joint venture were structured to maximize tax advantages *for investors,* as the court explained in detail in *Drobny I.*

In 1981 or 1982, the office of the District Director for the Illinois District of the IRS, based in Chicago, Illinois, commenced an investigation of the two aloe vera programs and Sheldon Drobny's involvement in them. Revenue Agent Noreen Rosen was in charge of this investigation, but she received assistance from Irving Feinglass, a former colleague of Drobny's at the IRS. Rosen concluded that the "research and development" losses incurred by the aloe vera enterprises would not be allowed as deductions on the investors' returns, and prepared a report (dated November 23, 1982) summarizing the basis for her recommendations. On December 16,1982, Agents Rosen and Feinglass met with Sheldon Drobny in his office to discuss the report and the possibility of settling the dispute, but no agreement was reached.

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[4] The promotional materials for the programs indicated that for each unit or share purchased, the expected net tax benefit would vary significantly depending on whether the investor was in the 50% or 70% tax bracket.

[5] Such deductions were not improper *per se*. As the Tax Court in *Drobny I* explained, a taxpayer could legitimately claim a deduction for "research or experimental expenditures which are paid or incurred by ... [the taxpayer] ... in connection with his trade or business." *Drobny I*, 86 T.C. at 1339-40 (citing 26 U.S.C. § 174(a)(1)), However, in order to constitute a "trade or business," the activity in question must have had the actual and honest objective of making a profit." Id. at 1339-43 (and authorities cited therein). An enterprise primarily intended to produce tax savings, without any significant likelihood of an economic profit, would not meet the definition of "trade or business' set forth by the Tax Court in *Drobny I*, and therefore the losses of such an enterprise would not be deductible. Id.

On April 15, 1983, the District Director for the Illinois District of the IRS sent a notice to the Drobnys formally disallowing the deductions claimed on their 1979 return in connection with the aloe vera promotions, and stating that Sheldon Drobny was liable for a civil fraud penalty (or "addition to tax") in the amount of $5,439, pursuant to 26 U.S.C. § 6653(b). The Drobnys filed a petition with the Tax Court contesting the notice of deficiency as well as the civil penalty, pursuant to 26 U.S.C. § 6213 (a).

The Drobnys' case came to trial during a particular time period when the IRS and the Tax Court were experiencing a tremendous increase in their respective caseloads, partly as a result of the popularity of "tax shelter" schemes similar to Drobny's. Sometime during 1983, Harmon Dow, then an Assistant Illinois IRS District Counsel, telephoned Tax Court Judge Charles R. Simpson, an acquaintance who was serving as Chairman of the Tax Court's Rules Committee, to discuss the large number of pending cases and how the court might best facilitate the handling of them. Dow was of the opinion that special procedures would be required to deal with the large number of cases. At Judge Simpson's request, Dow forwarded a computerized print-out of some 2,500 pending cases (including the Drobnys') to the judge. Subsequently, the Chief Judge of the Tax Court assigned the Drobnys' case and 14 others involving the aloe vera tax shelters to Judge Simpson, who set a hearing date for January 16, 1984 so that the court could identify several "test cases" that could proceed to trial during a special session of the court.[6] At the January hearing, the Drobnys' case was selected as a "test case" and set for trial on April 30, 1984. Counsel for the Drobnys did not object to the assignment of the case to Judge Simpson for the Chicago special session, nor did they challenge the selection of the case as a "test case," nor did they protest the scheduled trial date. When the Drobny case was called for trial, the Government was represented by William C. Sabin, Jr., who worked under the direction of Harmon Dow in the Office of the District Counsel for the Illinois District of the IRS. Sabin informed the Judge, in open court, that a criminal investigation of Drobny was pending.[7] Samotny, one of the potential defense witnesses in the civil case, was in the courtroom when this announcement was made.[8] The court granted the parties' joint oral motion for a continuance of the civil action until June 25, 1984. During the month of May, preceding the civil trial, the District Director for the IRS's Illinois District decided to discontinue the criminal investigation of Drobny, and confirmed this decision in a letter to Drobny's counsel.

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[6] By identifying and trying several "test cases" in advance, the court hoped to obviate the need for a trial in each and every one of the fifteen similar cases. Known as the "Chicago Experiment," this procedure was designed to expedite

The Drobnys' civil trial commenced in late June, after the District Counsel for the Illinois District had informed the Drobnys' attorney in writing of the IRS's decision not to proceed with the criminal investigation of Sheldon Drobny. Apart from Samotny, potential witnesses at the trial included Kamensky, the attorney who

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matters by encouraging the settlement of cases.

[7] On January 12, 1983, Agent Rosen had forwarded a "criminal fraud report" to the Criminal Investigation Division of the District Director's office, requesting that Drobny be criminally investigated for possible violations of 26 U.S.C. § 7201 (tax evasion) and 26 U.S.C. § 7206 (tax fraud/false statements). However, as the Tax Court in *Drobny II* noted, "no criminal investigation field work was performed on the criminal fraud report referral .... Petitioner was also recommended as a target in a grand jury request that identified several Chicago area individuals involved in abusive shelters, but he was not approved as a target." 69 T.C.M. at 2601

[8] Samotny ultimately testified at the trial, but only after the District Counsel assured him in writing that he was *not* the target of an investigation.

structured the aloe vera tax shelters, and Benjamin Rosenberg, an accountant and one of those whom Drobny had *per*suaded to invest in the tax shelters. Prior to trial, the Tax Court had ordered that the parties submit trial memoranda, which were to include, *inter alia,* a list of each side's prospective witnesses. The trial memorandum submitted by the Drobnys on the opening day of the trial identified five individuals whom the defense intended to call as witnesses, but the list included neither Kamensky nor Rosenberg as defense witnesses.

On the evening before Marvin Kamensky was scheduled to appear as a Government witness in the trial, Kamensky spoke by telephone with Sabin, the IRS's counsel. The following day, when the Government called Kamensky to the stand, he refused to answer questions concerning the aloe vera tax shelter programs, invoking his Fifth Amendment right not to testify. The Drobnys maintain that Sabin threatened Kamensky during the course of the phone conversation the night before his trial testimony; specifically, they claim that Sabin told Kamensky that if he "did not testify as the Government believed he should testify, the IRS could open a case against him and charge him with perjury." Sabin also stated (again according to the petitioners) that "he could give Mr. Kamensky no assurances that he was not the target of any investigations" by the IRS in connection with the aloe vera tax shelters.[9] These alleged threats, according to the Drobnys, were part of a "fraud upon the court perpetrated by the IRS, and provide a basis for vacating the Tax Court's 1986 decision.

When Kamensky invoked his Fifth Amendment right not to testify, the Government asked leave of the court to direct the witness to answer the questions put to him. The court then inquired of Kamensky the basis for his assertion of the Fifth

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[9] In mid-May 1984, prior to the trial, the District Counsel had provided written assurances to Kamensky's associate, Marc Samotny, stating that he was "not a target of any investigation." No similar assurances were provided to Kamensky.

Amendment privilege. The court heard testimony from both Kamensky and Sabin concerning the phone conversation of the previous night. Kamensky asserted that Sabin had threatened him during the phone conversation, saying that if he did not give testimony favorable to the IRS's case, the Government would file perjury charges against him. Kamensky also stated that he feared the Government was "out to get him" (i.e., that it would make him the target of a criminal investigation). Sabin denied that he had, at any time during this phone conversation, referred to a perjury charge and further stated: "[Kamensky] - to the best of our knowledge-well, I would say *categorically,* that he is not under any criminal investigation at this time [n]or does one appear imminent."[10] The court excused Kamensky from giving testimony concerning the tax shelters, concluding that although there was no pending criminal investigation of Kamensky, "there may be some basis for [Kamensky] to fear that any testimony by him might lead to ... criminal action against him."

In November of 1994, more than ten years after the 1984 trial, the Tax Court (Chief Judge Mary Ann Cohen, presiding) conducted a hearing on the petitioners' motion to vacate the decision in *Drobny I* (the denial of that motion is, of course, the subject of this appeal). Testifying before Chief Judge Cohen at this 1994 hearing, Kamensky addressed the allegedly threatening phone conversation with Sabin that had occurred some ten years previously, stating that be was "frightened" as a result of this conversation and immediately consulted an attorney, who advised him not to testify. From the vantage point of more than a decade, Kamensky recalled the substance of the conversation as follows:

> [Sabin] then said, and *this is many years ago,* but he said something to the effect that, We have

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[10] Sabin further testified that he had recently spoken with one of his superiors at the IRS, who informed him that an investigation of Kamensky was neither pending nor imminent.

> information about this transaction, and if you don't-this *is the way I remember it was meant, not necessarily the way it was said-If* you don't say what we want, we are going to get you on perjury. Or we-no, we could-I still-I remember the word be used, We could get you ... that word I do remember, We *could* get you. (emphasis added).

In this appeal, the Drobnys claim that the Government's "fraud upon the court" encompassed, not just the alleged intimidation of Kamensky, but also intimidation of a potential witness named Benjamin Rosenberg. Prior to the 1984 trial, the Drobnys asked Rosenberg to testify on their behalf, but he declined to do so. The Drobnys did not subpoena Rosenberg's testimony, nor did they list Rosenberg as a prospective witness in their trial memorandum. Rosenberg, an accountant, was one of the individuals Drobny had persuaded to invest in the aloe vera tax shelters. The Drobnys now allege that Rosenberg was reluctant to testify because of pressure from the Government. Specifically, they claim that Agent Feinglass approached Rosenberg prior to the trial and offered to settle Rosenberg's case, if he would agree to (1) testify that the aloe vera tax shelters were a sham, and (2) discharge his attorney, Randall Goulding. The Drobnys' claims concerning Rosenberg are not based upon any direct testimony from Rosenberg, but upon Drobny's testimony (at the 1994 hearing) concerning private conversations between himself and Rosenberg that allegedly occurred in "approximately 1992 or 1993." At the 1994 hearing on the Drobnys' motion to vacate, Rosenberg himself testified that "he did not recall telling petitioner [Sheldon Drobny] that he declined to testify because of implied threats by Feinglass." *Drobny II,* 69 T.C.M. at 2605.

On June 26, 1986, the Tax Court entered its decision in *Drobny I,* ruling in favor of the IRS. The opinion, authored by Judge Simpson, concluded that the Drobnys were not entitled to claim losses arising from the aloe vera programs' research and development expenditures as deductions on their jointly-filed 1979 return. The court disallowed these deductions because of compelling evidence that "the investment programs entered into by the petitioners were primarily intended to produce tax savings without any significant likelihood of an economic profit. *Drobny I*, 86 T.C. at 1343.[11] The tax tribunal also found that Sheldon Drobny was liable for a civil fraud penalty (or "addition to tax") under 26 *U.S.C.* § 6653(b), reasoning that he had "[known] that some or all of the research and experimental expenditures arising from the programs were not deductible and ... intentionally reported losses [as deductions] ... on his 1979 income tax return, resulting in a fraudulent underpayment of tax." *Drobny I,* 86 T.C. at 1350. The court in its opinion referred to the evidence of Sheldon Drobny's fraudulent conduct (i.e., his knowingly claiming impermissible deductions) as "considerable," noting that in light of Drobny's expertise, knowledge, and sophistication in the area of tax law, it was highly improbable that he had unknowingly claimed impermissible deductions. The petitioners failed to file a timely motion to vacate or revise the decision, much less a timely notice of appeal, and the Tax Court's decision in *Drobny I* became final on September 24, 1986. In early 1994, the Drobnys filed a motion to vacate the 1986 decision, pursuant to Tax Court Rule 162, asserting that the decision "was the result of a fraud on the court perpetrated by the Commissioner's wrongful, deceitful, and illegal conduct ... [that] prevent[ed] the Court: (1) from having the benefit of all the evidence and (2) from being able to render a fair and impartial decision." The Drobnys' motion was filed almost eight years after the decision in *Drobny I* became final. After the hearing,[12] the Tax Court concluded that the petitioners had fallen short of satisfying their burden of establishing a "fraud upon the court" and denied the motion to vacate *Drobny* I,[13] finding that the petitioners "ha[d] neither shown nor cited any specific examples of false statements, willful concealment, or other misrepresentations by respondent's counsel or other agents." *Drobny II,* 69 T.C.M. at 2605.

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[11] *See supra* note 5.

[12] The hearing was three days long and included testimony from a dozen witnesses as well as approximately 200 exhibits.

II. ISSUE

The issue presented is limited to the question of whether the Tax Court in *Drobny II* abused its discretion in denying the petitioners' motion to vacate *Drobny I.* We wish to make clear that we are not called upon to review the question of whether the deductions claimed by the Drobnys were improper and/or fraudulent. That was the substantive question of tax law presented in *Drobny I,* which we see no necessity to revisit. Our sole task is to determine whether the Tax Court's 1986 decision was procured by a "fraud upon the court."

III. DISCUSSION

A. Standard of Review

A Tax Court ruling denying a motion to vacate is reviewed under the abuse of discretion standard. *Harbold v. C.I.R.,* 51 F.3d 618, 621 (6th Cir. 1995) (and cases cited therein); *Abatti v. Commissioner,* 859 F.2d 1 15, 117 (9th Cir. 1988); *Lentin v. C.I.R.,* 243 F.2d 907, 908 (7th Cir. 1957) ("substantive motion to reconsider ... [is] within sound discretion of the Tax Court."). In an analogous context, i.e., when a district court has denied a motion to vacate under Federal Rule of Civil Procedure 60(b), we apply the same abuse of discretion standard. *See, e.g., Simons v. Gorsuch,* 715 F.2d 1248, 1253 (7th Cir. 1983) (denial of motion to vacate judgment for fraud and misrepresentation was not an abuse of discretion).

B. *"Fraud Upon the Court" as Grounds for*

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[13] The opinion in *Drobny II* was authored by *the Hon. Mary* Ann Cohen, Chief Judge of the U.S. Tax Court.

Vacating a Tax Court Decision

A decision of the Tax Court becomes final upon the expiration of the time allowed for the *filing of a* notice of appeal. 26 U.S.C. § 7481(a)(1); *see also Lentin,* 243 F.2d 907. Generally, a notice of appeal from a Tax Court decision must be filed within 90 days after the entry of the Tax Court's decision, but the timely filing of a motion to vacate or revise the decision extends the 90-day period. 26 U.S.C. § 7483; Fed.R.App.P. 13(a). Under Tax Court Rule 162, a motion to vacate or revise must be filed within thirty days after the Court's entry of the decision. Rule 162, 26 U.S.C. foll. § 7453. Thus, as previously noted, the decision in the Drobnys' case became final on September 24, 1986, as the petitioners filed neither a timely motion to vacate nor a timely notice of appeal.

"The Tax Court is a court of limited jurisdiction," and, unlike an Article III federal court, "lacks general equitable powers." *C.I.R. v. McCoy,* _U.S. _, 108 S.Ct. 217, 219 (1987). The authority of a court of limited jurisdiction to vacate final judgments has been narrowly construed. Specifically, once a decision of the Tax Court has become final, it may be vacated "only in certain narrowly circumscribed situations." *Curtis v. C.I.R..,* 72 T.C.M. (CCH) 369, _ (1996); *Kenner v. C.I.R.,* 387 F.2d 689, 690 (7th Cir.), *cert. denied,* 393 U.S. 841 (1968) (the finality of a tax court judgment "precludes any subsequent reconsideration by the tax court, at least on such grounds as mistake, newly discovered evidence, and the like."). Indeed, this circuit has continued to recognize only a single, narrow exception to the general rule of finality prescribed by Congress in 26 U.S.C. § 7481. In *Kenner,* this court held that the Tax Court could set aside an otherwise final decision only if the party seeking to vacate the decision could convincingly establish that the decision resulted from a "fraud upon the court." 387 F.2d 689. In establishing this limited exception to the rule of finality, the court reasoned as follows:

> If any room has been left for a relaxation of the

> statutory finality in order to permit the tax court to consider whether its decision is the product of a fraud upon it, that is all that has been left.... We think, however, that it can be reasoned that a *decision produced by fraud on the court is not in essence a decision* at all, and never becomes Final. It is most difficult to assume that Congress intended that a decision procured by fraud on the tax court could not be reached by any procedure in any tribunal, once the possibilities of direct review were exhausted. If a *convincing* case of *palpable* fraud on the court were presented, it is hard to justify a holding that it could not be considered. We conclude that the tax court has power to inquire into the integrity of its own decision even when such decision has become final and immutable in all other respects as a result of exhaustion of direct review or expiration of the time allowed for seeking review.

Id. at 691 (emphasis added). The Kenner court also emphasized that the burden of proof rests squarely with the party seeking to set aside the prior decision, and stated that this burden could not be met simply by making "a broad assertion that the tax court decision [was] tainted with fraud." *Id.* Rather, "there is a *heavy burden* . . . upon the one who seeks to impeach an order or decree of a court," who must come forward with *"specific facts* which will pretty plainly impugn the official record." *Id.*

Defining the term "fraud upon the court," this court in its Kenner decision stated that the alleged improper conduct must rise to the level of an *"unconscionable plan or scheme ... designed to improperly influence the court in its decision"* before it may be deemed a "fraud upon the Court." *Id.* (quotations omitted) (emphasis added). The *court stressed* that not all deceptive or improper conduct rises to the level of a "fraud upon the court." Rather, "'I [f]raud upon the court' . . . embrace[s] only that species of fraud which does, or attempts to, defile the court itself, or is a fraud perpetrated by officers of the court so *that the judicial* machinery can *not perform in the usual manner its impartial task of adjudging cases* that are presented for adjudication," Id. (quoting 7 *Moore's Federal Practice,* 2d ed., p. 512, § 60.23). Thus, the "import *[of Kenner]* . . . is to suggest that [the Tax Court] can reexamine an otherwise final decision when such decision was produced by [a] 'fraud upon the court' *of the most egregious nature,* and when such fraud *goes to the very heart of the adjudicative process." Deutsch v. C.I.R.*, 34 T.C.M. (CCH) 387, - (1975) (emphasis added). The narrow and limited definition of "fraud upon the court" set forth in *Kenner* "reflects the policy of putting an end to litigation," *id.*, and serves the "important legal and social interest" in preserving the finality of judgments, *Toscano v. C.I.R.*, 441 F.2d 930, 934 (9th Cir. 1971). Like this court in Kenner, all of the circuits that permit the vacating of an earlier Tax Court decision on the basis of fraud have articulated a very narrow definition of "fraud upon the court" and have underscored the heavy burden faced by a party who *seeks* to set aside a prior Tax Court decision. *See Harbold,* 51 F.3d at 622; *Aoude v. Mobil Oil Corp.*, 892 F.2d 1115, 1118 (IST Cir. 1989); *Abatti*, 859 F.2d at 118; *Senate Realty Corp. v. C.I.R..*, 511 F.2d 929, 931 (2d Cir. 1975); *Stickler v. C.I.R.*, 464 F.2d 368, 370 (3d Cir. 1972); *see also* Annotation, *Power of Tax Court to Grant Leave to File Motion to Vacate Its Final Decision on Ground of Fraud Upon the Court,* 24 A.L.R. Fed. 697 (1975) (1995 Supp.).

One particular aspect of the definition of "fraud upon the court" must also be clarified. The petitioners argue that "fraud upon the court," as interpreted in this circuit, does not require a showing that the alleged "fraud upon the court" was material, i.e., that it affected the outcome of the case which the petitioners seek to vacate. According to the Drobnys, "it makes no difference whether or to what extent the prior decision was affected by the fraud." We are of the opinion that the petitioners were required to demonstrate, not only that the respondent engaged in conduct that was *intended* to mislead the court, but of paramount importance - that the actual conduct affected the outcome of their case, We reject the petitioners' interpretation of what constitutes "fraud upon the court" and affirm the Tax Court's denial of the Drobnys' motion to vacate *Drobny I.*[14] Again we rely upon Kenner, which held that the appellant could not prevail on his motion to vacate because he had left this court "in the dark as to how the [IRS] agents fraudulently induced the court to decide against Dr. Kenner." 397 F.2d at 692 (emphasis added). The dictionary defines "induce" as "to lead or move by influence or persuasion," "to bring about the occurrence of; cause." *American Heritage Dictionary* 657 (2d College Edition 1982). Thus, it is clear from the language employed by this court in *Kenner* that in addition to establishing improper conduct, a taxpayer who attempts to set aside a prior judgment of the Tax Court must also explain how the alleged conduct induced, caused, or had a material effect upon the decision. Our holding (or rather, our clarification of *Kenner)* also finds support in various decisions of the United States Tax Court. For example, in *Murdock v. C.I.R..,* 72 T.C.M. 1324 (1996), the Tax Court stated that in order to prove "fraud upon the court," a petitioner seeking to vacate a decision must establish that "an intentional plan of deception designed to improperly in*fluence the Court in its decision has had such an effect* on *the court." See also Chao v.*

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[14] We disagree with the Drobnys' argument that a fraud upon the court" can occur even if the allegedly improper conduct does not affect the outcome of the court's deliberations. Under the common law of fraud, a misrepresentation in and of itself (i.e., one that is not relied upon to the detriment of the defrauded party) is not actionable. In Illinois, for example, "the elements of common law fraud are: (1) a false statement of material fact; (2) by one who knows or believes it to be false; (3) made with the intent to induce action by another in reliance on the statement; *(4) action by the other in reliance on the truthfulness of the statement; and (5) injury to the other resulting from that reliance." Athey Products Corp. v. Harris Bank Roselle,* 89 F.3d 430,
434 (7th Cir. 1996) (emphasis added).

C.I.R.., 92 T.C. 1141, 1144 (1989) (motion to vacate denied because same result would have been reached even in the absence of the alleged fraud upon the court); *Abatti,* 86 T.C. 1319, 1325 (1986) (petitioner must show that deception "designed to improperly influence the court in its decision *has had such an effect* on the court.").[15] We see no reason to alter our previous, narrow definition of "fraud upon the court," which reinforces the salutary general rule that final judgments are, in fact, final. We do not agree with the petitioners' argument that a final judgment of the Tax Court should be subject to attack (possibly, as in this case, many *years later)* when the *allegedly improper con*duct had no effect on the outcome of the decision. The "The rule of finality" lends stability to our legal system, and it is especially important in this litigious era when adversely affected parties seize upon almost any opportunity to prolong litigation. Accordingly, we re-emphasize that under our case law the "fraud upon the court" exception to the rule of finality is a *narrow* one, and the party seeking to vacate a prior decision must establish that the allegedly "fraudulent" conduct had its intended effect of misleading the court.

C. Did the Agents or Attorneys of the Commissioner Commit a "Fraud Upon the Court" in Drobny I?

The next question we must address is whether the Drobnys have met their "heavy burden" of establishing a "fraud upon the court" in connection with *Drobny I,* and whether the Tax Court abused its discretion in denying the petitioners' motion to vacate. The Drobnys assert that the Commissioner's "attorneys and agents engaged in a scheme to prevent [them] from fully and fairly presenting their defense in the 1984 trial" and that, taken as a whole, this conduct "constituted fraud on the court." In arguing that a "fraud upon the court" took place, the Drobnys have adopted a "buckshot approach . . . hop[ing] that a pellet will strike." *United States v. Boyles,* 57 F.3d 535, 548 (7th Cir. 1995). They allege the following improprieties: (1) Assistant District Counsel Dow's *ex parte* communication with Judge Simpson concerning the scheduling of pending cases (including the Drobny case) for trial, (2) the referral of Drobny to the Criminal Investigation Division as well as IRS Attorney Sabin's mention of this referral in open court in the presence of a potential witness (Samotny), and (3) intimidation of witnesses (including Kamensky and Rosenberg) by the Commissioner's agents and attorneys. After carefully considering these allegations (individually and in combination), the Tax Court concluded that the petitioners had ailed to demonstrate that the Commissioner's attorneys or agents were guilty of misrepresentation or concealment or that the Court was in any way deceived as to the facts on which it based its decision." *Drobny II,* 69 T.C.M. (CCH) at 2607. Our review of the record persuades us that the Tax Court was correct when it found that the petitioners had failed to meet their "heavy burden" of demonstrating a "fraud upon the court," *i.e.*, "an unconscionable plan or scheme" which was "designed to [and did] improperly influence the court in its decision." Kenner, 387 F.2d at 691. Accordingly, we hold that the Tax Court did not abuse its discretion by denying the petitioners' motion to vacate.

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[15] Supreme Court's decision in *Hazel-Atlas Glass Co. v. Hartford Empire Co.*, 322 U.S. 238 (1944), discussed in the parties' briefs, did not involve the powers of the Tax Court to vacate prior decisions, but rather the equitable powers of a federal circuit court to set aside judgments procured by fraud. Unfortunately, while the Hazel court did discuss the issue of "fraud upon the court," its holding is somewhat unclear with regard to the question of whether such a fraud must be material in order to justify setting aside a previous decision. Because this court's opinion in *Kenner* is on point, it resolves the question before us and we choose to forego a discussion of *Hazel* at this time.

1. Ex Parte Communication *Between Dow (IRS) and Judge Simpson*

The petitioners contend that one aspect of the alleged "fraud upon the court" took place even before their trial began, when Assistant District Counsel Harmon Dow contacted Judge Simpson (sometime in 1983) regarding the scheduling of a large number of pending tax shelter cases. As noted above, Judge Simpson was the then Chairman of the Tax Court's Rules Committee, and known to Dow as such. Before telephoning Judge Simpson, Dow obtained clearance from his superior, the District Counsel for the IRS. The petitioners now maintain that Dow initiated this *ex parte* contact in order to "manipulat[e] the judicial selection process [and] . . . secure for the trial, the judge of [the IRS's] selection."[16]

Initially, it should be pointed out that following the conversation with Dow, Judge Simpson did not assign the tax shelter cases to himself Rather, it was the Chief Judge of the Tax Court who assigned these cases to Judge Simpson, without objection from the Drobnys,[17] for a special session in Chicago, Illinois. Thus, it is at best tenuous for the Drobnys to argue that the conversation between Dow and Simpson affected the selection of a particular trial judge for the Drobnys' case.

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[16] The petitioners neither objected to the assignment of their case to Judge Simpson nor did they request that he recuse himself. The Drobnys' motion to vacate, filed with the Tax Court in 1994, did not allege that any improper *ex parte* communication had occurred between Dow and Judge Simpson, but this allegation was raised during questioning of Dow by Drobny's counsel at the 1994 evidentiary hearing on the motion to vacate. As explained *supra*, Dow acknowledged telephoning Judge Simpson but vigorously denied any impropriety. In their brief to this court, the petitioners insist, contrary to Dow's sworn testimony, that Dow characterized the tax shelter cases as "abusive tax shelter cases" in the course of his communication with Judge Simpson. This allegation would appear to be pure speculation, or if the petitioners do have a concrete basis for this claim, they have failed to make it a part of the record.

[17] The record before us does not reflect the precise date of either Dow's conversation with Judge Simpson (sometime in 1983) or the exact date when the Chief Judge of the Tax Court assigned the tax shelter cases to Judge Simpson. It is clear from the documents on file that the assignment of the cases took place sometime in the latter half of 1983, after the petitioners had requested of the Tax Court that their case be tried in Chicago, Illinois.

The contact between Dow and Judge Simpson was indeed *ex parte,* in the sense that it occurred without either the knowledge or consent of the Drobnys or the other petitioners whose tax shelter cases were then pending. However, as this court has observed on previous occasions, "[n]ot every *ex parte* communication is a procedural defect so substantial and so likely to cause prejudice that it entitles the claimant to an entirely new ... proceeding." *Shidaker v. Carlin,* 782 F.2d 746, 752 (7th Cir. 1986); *see also United States v. Napue,* 834 F.2d 1311, 1316 (7th Cir. 1987) *(ex parte* proceedings in the criminal context are "disfavored," but do not automatically constitute reversible error); American Bar Association, *Annotated Model Rules of Professional Conduct* 338-39 (3d ed. 1996) ("Although *ex parte* communications may give rise to discipline, they do not necessarily constitute grounds for reversal.").

Furthermore, because neither the specifics nor the merits of the individual tax shelter cases were discussed during the conversation, we are of the opinion that the discussion between Dow and Judge Simpson concerning court scheduling was not improper. In our considerate view, this discussion fell far short of rising to the level of an ethical violation, much less a deliberate "fraud upon the court." As a general rule, we frown upon any communication between a judge and any party to litigation pending before that judge, *when* the communication occurs outside the presence of the other party (or parties) to the suit and concerns a substantive matter. However, as a matter of professional ethics, it is well-established that an *ex parte* communication which does not concern the *merits* of the case is permissible. Charles W. Wolfram, *Modern Legal Ethics* 605 (West 1986); DR 7-110(B). The Drobnys allege, without support in the record, that Dow and Judge Simpson not only discussed the merits of the pending tax shelter cases, but that Dow "stigmatized" the cases by referring to them as cases involving "abusive shelters." However, when Dow testified at the Tax Court hearing in 1994 (conducted pursuant to the Drobnys' motion to vacate), it is of interest to note that he specifically and categorically denied that be ever characterized the tax shelter cases as "abusive," and maintained under oath that he and the judge "didn't talk about the substance of the [individual] cases," except to refer to them as tax shelter cases with similarities that might warrant consolidated or special proceedings of some kind.[18] According to Dow, the discussion was limited to generalities, including the "tremendous influx" of tax shelter cases as well as Dow's view that the Tax Court "ought to look into a different method of dealing with these cases" which "could not be handled by the ordinary processes of the Tax Court." The record is barren of any evidence, much less testimony, to contradict Dow's version of this conversation. Thus, on the basis of this record, we do not agree with the Drobnys' contention that Dow initiated contact with Judge Simpson in order to influence the selection of a trial judge, and we refuse to hold-on the basis of nothing more than the petitioners' bald and unsupported accusations that the conversation referred to was part of an overall "unconscionable plan or scheme . . . to improperly influence the court in its decision." Kenner, 387 F.2d at 691. In short, the innocuous communication between Dow and Judge Simpson concerning an improved procedure for dealing with the Tax Court's overburdened docket cannot serve as a basis for setting aside the decision in *Drobny I*.

The facts demonstrate that Assistant District Counsel Dow, with the approval of the District Counsel, was responding to the demands of an unprecedented caseload and that he contacted Judge Simpson (then Chairman of the Tax Court Rules Committee) to discuss the purely *administrative* issue of how best to proceed with the large number of pending tax shelter cases.[19] Dow's goal in contacting Judge Simpson was clearly to expedite the administration of justice, which can only be described as a laudable objective, for we all are aware of the old tried yet true cliche that "Justice delayed is justice denied."

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[18] As noted above, the court eventually adopted the so-called "Chicago experiment," in which representative "test cases" were tried first in order to encourage settlement in other, similar cases.

2. Criminal *Investigation Referral*

As part of their "buckshot approach" to establishing a "fraud upon the court," the petitioners also claim that it was improper for Agent Rosen to refer Sheldon Drobny to the Criminal Investigation Division (part of the Office of the District Director for the Illinois District), for possible violations of 26 U.S.C. § 7201 (tax evasion) and 26 U.S.C. § 7206 (tax fraud/false statements). Although the facts of Drobny's case may well have warranted at least an investigation (if not the filing of formal criminal charges), we see no reason to even discuss the propriety of the criminal referral for a number of reasons, not the least of which is that the referral occurred in early 1983, *before* the Tax Court had jurisdiction over the Drobny case; thus, the referral *in and of itself* could not have been part of a "fraud upon the court."

The Drobnys also assert that it was improper for the Government's counsel to mention the criminal referral in open court when the Drobny case was first called for trial, because Samotny, a potential witness, was present in court. We fail to see how this truthful disclosure to the court, concerning the pendency of a criminal investigation,[20] could be interpreted as being part and parcel of a deliberate scheme or conspiracy to commit a "fraud upon the court," as the Drobnys maintain, This matter was properly raised by the Government's lawyer in order that the trial judge might be fully informed as to the status of all related matters and make an informed judgment as to whether or not to delay the proceedings. More importantly, as the Tax Court observed, the Drobnys have failed to establish "how, if at all, Samotny's testimony was affected by [these] truthful statements. . . ." *Drobny II,* 69 T.C.M. at 2606. Indeed, the record reflects that shortly after the criminal investigation was mentioned in Samotny's presence, the District Counsel provided Samotny with a written assurance that be was not the target of any criminal investigation by the IRS (for his role in the aloe vera tax shelters). In light of these steps taken by the IRS to alleviate Samotny's fears of criminal prosecution, we reject the Drobnys' contention that the reference to the criminal investigation in Drobny's case intimidated Samotny and thus constituted a "fraud upon the court."

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[19] As noted by the Tax Court in its decision, Congress at this time had recognized the difficulties posed by the Tax Court's sizable backlog of cases and taken steps to enact appropriate legislation. H. Conf. Rep. No. 861, 98th Cong., 2d Sess. 985-86, 1984-3 C.B. (Vol. 2) 239-40.

3. *Intimidation of Witnesses*

Perhaps the only claim of the Drobnys that merits more in-depth discussion is their assertion that the Commissioner's agents and attorneys engaged in the intimidation of witnesses as part of a deliberate effort to improperly influence the decision of the Tax Court in *Drobny I.* When it is proven that an officer of the court (or anyone, for that matter) has attempted to intimidate a witness, such conduct is not only a serious ethical impropriety but is also frequently prosecuted as a criminal violation.[21] However, our inquiry deals with the question of whether the attorneys and agents of the Commissioner, through their interaction with certain witnesses or potential witnesses, attempted to perpetrate a fraud upon the court, i.e., a deliberate fraud that prevented the court from "Perform[ing] in the usual manner its impartial task of adjudging cases." *Kenner*, 387 F.2d at 691.

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[20] A criminal investigation of Drobny was pending as of the time his civil case was first called for trial in late April. An internal IRS memorandum circulated in early May 1984 referred to this investigation as "open and inactive," and after the investigation was officially closed on May 21, 1984, another IRS memo noted that no "criminal investigation field work" had ever been performed by the Criminal Investigation Division with respect to Drobny's case.

The petitioners claim that Marvin Kamensky (whom the Drobnys now portray as a "key" defense witness) invoked the Fifth Amendment at trial because of alleged threats made by Sabin (counsel for the Commissioner) on the eve of Kamensky's scheduled testimony. The petitioners allege that Sabin told Kamensky that if he did not give testimony favorable to the Commissioner, the IRS could open a case against him and charge him with perjury. According to the Drobnys, Sabin refused to provide any assurances that Kamensky was not the target of a criminal investigation (whether he was in a position to give such assurances, without clearance from his superiors at the IRS, is not included in this record).

As an initial matter, we note that Kamensky was not even listed as a defense witness (much less a "key witness") in the petitioners' trial memorandum, so that we are skeptical, to say the least, of the Drobnys' argument before this court that Kamensky was "the witness most vital to their defense." Kamensky was the *Government's* witness (Sabin had issued a *subpoena duces tecum* on April 5, 1984 commanding Kamensky to appear before the Tax Court in the Drobny trial). Although the Drobnys assert that Sabin improperly threatened Kamensky with perjury charges, Sabin (appearing before Judge Simpson in 1984) emphatically denied ever *mentioning*, much less threatening, possible peijury charges.

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[21] In Illinois, for example, witness and/or juror intimidation is a felony punishable by 2-5 years imprisonment. Ill. Ann. Stat. ch. 720, para. 5/32-4 (Smith-Hurd 1996); *see also Model Rules of Professional Conduct* Rules 3.4 and 4.2 (1994).

The evidence of a direct threat by Sabin rests largely on the testimony that Kamensky provided at the 1994 hearing on the motion to vacate, *ten years after the alleged threat took place.* At this hearing, Kamensky recalled that his telephone conversation with Sabin left him "more frightened than ... [he could] ever remember being ... in [his] life." With respect to the specifics of the conversation, however, Kamensky was far less certain. Kamensky qualified and limited his accusation by stating that Sabin mentioned the *possibility* of a perjury charge, and while Kamensky claimed to remember this long-ago conversation, he stated with some equivocation: "this is the way I *remember* it was meant, not *necessarily the way it was said."* This tentative testimony from Kaniensky, referring to statements allegedly made some ten years earlier, establishes that he personally may have *perceived* Sabin's comments on that particular date as threatening, but Kamensky's 1994 testimony falls far short of convincingly demonstrating that Sabin engaged in direct threats that would constitute witness intimidation and/or a fraud upon the court. Sabin's alleged comment that he was unable to provide any assurances to Kamensky that he was not the subject of an IRS investigation in connection with the tax shelters was obviously made in reply to some kind of a request from Kamensky. We find nothing improper about Sabin's comment, if in fact it was made at all. Kamensky participated actively in the creation of the tax shelters and, although he may have keenly desired a statement from the IRS that he was not the target of an investigation, the Government was not required to give him such a guarantee (nor is it clear whether Sabin was even in a position to provide such an assurance without first consulting with his superiors).[22]

Furthermore, we note that on the day Kamensky was scheduled to testify, Judge Simpson was promptly and fully informed concerning the telephone conversation of the night before (which the petitioners now claim was improper, threatening, and part of a "fraud upon the court"). As noted by the court in *Drobny II:*

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[22] Nor do we accept the petitioners' argument that Kamensky should have received such assurances merely because his colleague Samotny did.

> During the hearing in 1984, Kamensky's counsel complained that respondent had wrongfully caused Kamensky to come to Court and assert his 5th amendment privilege. *Kamensky gave his view of his conversation with Sabin, and Sabin gave his view. Neither the communications nor the basis for the assertion of the privilege were concealed from or misrepresented to petitioners or to the Court.*

69 T.C.M. at 2606 (emphasis added). Although Judge Simpson excused Kamensky from further testimony on the basis of his invocation of his Fifth Amendment privilege, the judge did not so much as even hint that Sabin had engaged in any improper conduct, much less make a finding that Sabin's actions amounted to a fraud upon the court, i.e., that they had prevented the court from "perform[ing] in the usual manner its impartial task of adjudging cases." *Kenner,* 387 F.2d at 691.

Was Sabin's conduct vis a vis Kamensky ethically proper? We state with certainty that there is nothing improper about a Government attorney speaking with a Government witness prior to trial. Discussion between an attorney and his witness is a proper pre-trial procedure. If Sabin merely cautioned Kamensky that the Government wanted him to tell the truth and nothing but the truth, while reminding him of the seriousness of giving testimony under oath and committing perjury, that would also be proper and by no means unusual. Sabin denies having made any threatening comments, as alleged by the Drobnys. The trial judge did not make any factual findings on the question of whether Sabin engaged in such "threats," and it is well beyond our role as an appellate court to do so. *See, e.g., United States v. Wesson,* 33 F.3d 788, 792 (7th

Cir. 1994) ("We will not reweigh the evidence or make credibility determinations; as an appellate court viewing the trial record, we are incapable of assuming the role of the factfinder."). In this regard, it is important to remember that while we appellate judges are confined to the "cold pages of a transcript" and thus cannot assess witness credibility, the judge or jury has "the opportunity to observe the verbal and non-verbal behavior of the witnesses focusing on the subject's reactions and responses to interrogatories, their facial expressions, attitudes, tone of voice, eye contact, posture and body movements." *United States v. Lakich,* 23 F.3d 1203, 1210-11 (7th Cir. 1994).

Fortunately, we need not resolve the factual question of what transpired in the conversation between Sabin and Kamensky in order to determine whether Sabin's conduct contributed to an alleged "fraud upon the court." That is because, even if we were to assume that Sabin did engage in improper threats of the kind alleged by the Drobnys, his conduct did not affect the outcome of the decision in *Drobny I* and for this reason it did not rise to the level of a "fraud upon the court" as defined in this circuit. The Drobnys argue that Kamensky's testimony, if proffered, would have helped their case. According to the petitioners, Kamensky-mysteriously unlisted in their trial memorandum and only now described as a "key witness"-would have corroborated Sheldon Drobny's testimony that he relied upon Kamensky for guidance regarding the aloe vera tax shelters, and thus did not know that the deductions were improper. If Kamensky (figuratively speaking, Drobny's "partner in crime") bad given testimony favorable to Drobny, we think it unlikely that this testimony would have persuaded Judge Simpson of Drobny's innocence in light of (1) Drobny's sophistication and expertise in the area of tax shelters, (2) his substantial involvement in the promotion of the aloe vera programs, and (3) the fact that Drobny (not Kamensky) was the one who actually prepared the Drobnys' joint 1979 tax return. We are certainly doubtful that the testimony of an associate who was directly involved in the creation and promotion of the sham tax shelters would have made any difference to the judge's ruling in the case. In short, we agree with the Tax Court that "[adding] the subjective opinions of other interested persons in the litigation [i.e., Kamensky] would have not changed the objective facts upon which the [1986] opinion [was] based." *Drobny II,* 69 T.C.M. at 2606.

The Drobnys also assert that prior to the trial, IRS Agent Feinglass "frightened [Benjamin] Rosenberg into not testifying" by telling him that the IRS would only agree to settle his case if he agreed (1) to testify that the aloe vera tax shelters were shams, and (2) to fire his attorney, Randall Goulding.[23] Although the Drobnys now describe Rosenberg as another of their "key witnesses" (like Kamensky) we find it strange that he was not even listed as a defense witness in the petitioners' trial memorandum and that the defense never even attempted to subpoena him to testify. Indeed, Steven Nagler, the petitioners' attorney in the 1984 trial, has stated that the defense "didn't consider [Rosenberg] crucial to the case." The allegation that Rosenberg was somehow intimidated by Feinglass does not rest on direct testimony in the record, but upon Sheldon Drobny's hearsay testimony at the 1994 hearing concerning conversations he had with Rosenberg in "approximately 1992 or 1993." Rosenberg's own testimony at the 1994 hearing was that "[h]e did not recall telling Drobny that he declined to testify because of implied threats by Feinglass." *Drobny II,* 69 T.C.M. at 2605. Furthermore, if we are to credit the 1994 testimony of petitioner Sheldon Drobny, it would appear that Rosenberg told Drobny he was most fearful of official proceedings of any and all kinds, for he was a survivor of the Holocaust. Thus, Agent Feinglass' alleged comments were not the only (and perhaps not even the most important) plausible explanation for Rosenberg's unwillingness to testify.

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[23] At the 1994 hearing on their motion to vacate, the petitioners sought to introduce the testimony of Francis Emmons, an investor in a *different* tax shelter – who was also represented by Goulding. In an offer of proof, it was established that Emmons would testify that one of Feinglass' colleagues, Loren Gore, made a settlement offer similar to the one allegedly made to Rosenberg, also conditioned on willingness to fire Goulding. This offer was allegedly made about ***nine months after the Drobnys' trial concluded***. Exercising its discretion to admit or exclude testimony, the court ruled that Emmons' preffered testimony was irrelevant and inadmissible because it "was not directed at *petitioner's* right to a fair trial," and, even if admitted, "would not persuade [the court] that such conduct constituted a fraud on the Court in *this case.*" *Drobny II,* 69 T.C.M. at 2605 (emphasis added). It is well-established that "we reverse a [trial court's] decision to admit or exclude evidence only if there was a clear abuse of discretion." *Carroll v. Acme-Cleveland Corp.*, 955 F.2d 1107, 1114 (7th Cir. 1992). The Tax Court did not commit an abuse of discretion (much less a clear abuse of discretion) when excluding Emmons' testimony, for this testimony would have shed no light on the question before the court, which was why *Rosenberg* refused to testify in tne Drobny trial.

In order to establish that the Government's alleged intimidation of Rosenberg amounted to a fraud upon the court, the Drobnys must demonstrate how the "loss" of Rosenberg's testimony (which, we repeat, they never deemed crucial to begin with) affected the outcome of their case. However, the petitioners have once again failed to explain how the testimony of this additional, purportedly "key" witness would have helped their case. Based upon all of the facts and circumstances concerning the prospective witness Rosenberg, we are of the opinion that the Tax Court did not when it found that Feinglass' alleged intimidation of Rosenberg fell short of being a "fraud upon the court."

To summarize, we agree with the Tax Court's conclusions as to each of the alleged improprieties discussed above and hold that none of them, taken alone or considered in combination, amounted to a "fraud upon the court" (as that term has been defined by this court and others). Thus, the Tax Court did not abuse its discretion when it denied the Drobnys' motion to vacate *Drobny I.* We are mindful of the extreme difficulty of re-constructing events that occurred during a trial ten years ago, and for this reason we give deference to the *Drobny II* court's findings. We also note that the almost eight-year delay in filing a motion to vacate is solely attributable to the petitioners,[24] Much of the allegedly improper conduct by the Commissioner's agents and attorneys either occurred in open court (the reference to the criminal referral at the commencement of the trial in 1984) or was well known to the Drobnys at the time of the trial (the alleged intimidation of Kamensky). Yet the Drobnys, for reasons unexplained in this record, failed to file their motion to vacate until almost eight years after *Drobny I* became final, and they have offered no explanation for this extended delay. The Tax Court in *Drobny II* observed that "[b]ecause of the passage of time, each of the witnesses at the [1994] hearing [on the motion to vacate] . . . indicated some lack of recollection of the sequence of events and specific conversations that petitioner alleged to have occurred." 69 T.C.M. at 2604[25]

IV. CONCLUSION

We agree with the Commissioner that "[i]t is time to put the decision in *Drobny I* to rest." Decisions of the Tax Court which become final may not thereafter be vacated, unless the petitioner is able to convincingly demonstrate that the decision was procured by a "fraud upon the court," i.e., an *"unconscionable plan or scheme . . . designed to improperly influence the court in its decision."*

---

[24] The improper deductions were made on the Drobnys' 1979 return. In 1983, following investigation by the IRS and attempts to settle the matter, the IRS sent a notice to the Drobnys formally disallowing the deductions and assessing an "addition to tax" for civil tax fraud. The Drobnys contested the notice of deficiency and the addition to tax, and their case came to trial in Spring 1984. The Tax Court's decision in *Drobny I* became final in 1986. However, the Drobnys did not file their motion to vacate *Drobny I* until February 1994.

[25] In some instances, the delay and consequent loss of recollection by witnesses actually hampers the effectiveness of the Drobnys' arguments. For example, as discussed above, Kamensky's 1994 testimony concerning the alleged threats by Sabin is very tentative and uncertain, and provides, at best, only weak support for the accusation that the Government engaged in improper conduct.

Kenner, 387 F.2d at 691. The Drobnys have not met their "heavy burden" of establishing that the 1986 decision of the Tax Court was procured by a "fraud upon the court." Id. Most importantly, like the petitioner in *Kenner*, the Drobnys have "left us in the dark" concerning the critical issue of *how* the allegedly fraudulent conduct of the respondent *"induced"* or led the court to decide against them. Id. at 692. Because the Drobnys have failed to prove that any of the respondent's allegedly improper acts had any influence upon the outcome of their trial, we hold that the Tax Court did not abuse its discretion by refusing to set aside its earlier decision.

AFFIRMED.

A true Copy:
Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

SHELDON AND ANITA DROBNY, Petitioners v.

COMMISSIONER OF

INTERNAL REVENUE, Respondent

Docket No. 16985-83

UNITED STATES TAX COURT

T.C. Memo 1995-209; 1995 Tax Ct. Memo LEXIS 210; 69

T.C.M.

(CCH) 2600

May 17, 1995, Filed

DISPOSITION: An appropriate order will be issued denying petitioners' motion for leave to file motion to vacate.

COUNSEL: For petitioners: Harvey M. Silets and Jaye Quadrozzi.

For respondent: Matthew J. Fritz and James W. Ruger.

JUDGES: COHEN

OPINION BY: COHEN

OPINION: MEMORANDUM OPINION

COHEN, Judge: Petitioners seek to vacate the decision entered June 26, 1986, pursuant to the Opinion of the Court in Drobny v. Commissioner, 86 T.C. 1326 (1986). Petitioners contend that the decision was procured by fraud on the Court engaged in by respondent's counsel and agents.

Background

The factual background of this case is found in the Opinion of the Court at 86 T.C. at 1328-1339. Only facts material to the pending motion are repeated here.

Petitioner Sheldon Drobny (petitioner) was an Internal Revenue Service (IRS) agent from 1967 through 1971 and began private practice as a certified public accountant in 1971. During the 1970's, petitioner began to promote tax shelters. Some of the shelters were promoted in association with Marvin Kamensky (Kamensky), who was known in Chicago, Illinois, as an attorney with experience in the formation of research and development tax shelters. During 1979 and early 1980, Marc Z. Samotny (Samotny), an associate of Kamensky, prepared documents involved in the transactions that were a part of the tax shelter program.

In November 1979, petitioner was informed by Kamensky of two tax shelter programs based on a substance known as aloe vera. Kamensky and Samotny persuaded petitioner to solicit investors from among his clients and associates. Petitioner and his firm were identified in the offering materials as promoters of the program and as members of an accounting firm that specialized in financial arid tax consultation.

Petitioners purchased an interest in each of the two research and development programs and deducted certain amounts on their 1979 joint Federal income tax return as their share of losses resulting from the programs. On April 15, 1983, respondent sent to petitioners a statutory notice disallowing the deductions and asserting that petitioner was liable for the addition to tax for fraud.

During the hearing on petitioners' presently pending motion, other facts concerning the audit and investigation of the two programs in issue and petitioner's involvement in them were developed. In 1981 or 1982, revenue agent Noreen Rosen (Rosen) was assigned to conduct an audit of the programs. Another revenue agent, Irving Feinglass (Feinglass), was a member of the same agent group but was not assigned to audit petitioners' return. On December 16, 1982, Rosen and Feinglass met with petitioner at petitioner's office. At that meeting, Rosen showed petitioner her report dated November 23, 1982, in which she proposed disallowing the claimed losses of the investors in the programs. Feinglass made an offer to petitioner to allow as a deduction the amount of cash paid by each participant for his or her interest in the program, with no penalties to be asserted against anyone. Petitioner did not immediately accept the offer, indicating that he would contact the investors.

On January 12, 1983, Rosen forwarded to the Criminal Investigation Division a criminal fraud referral report regarding petitioner. No criminal investigation field work was performed on the criminal fraud report referral, however. Petitioner was also recommended as a target in a grand jury request that identified several Chicago area individuals involved in abusive tax shelters, but he was not approved as a target.

The development of the program in issue here paralleled similar programs throughout the United States during the same period, resulting in a tremendous increase in the caseload of the IRS and this Court. From 1974 to 1984, the number of cases docketed in the Court more than quadrupled. Many of the new cases originated in the Chicago, Illinois, area.

Sometime during 1983, Harmon Dow (Dow), who was then assistant district counsel in Chicago, telephoned Judge Charles R. Simpson, a judge of the Court with whom Dow was acquainted. Dow told Judge Simpson that the Chicago office had a tremendous influx of cases that, in Dow's opinion, could not be handled by the ordinary processes of the Tax Court. Dow suggested that the Tax

Court should look into a different method of dealing with these cases. Judge Simpson asked Dow to send to him a computerized list of the cases, which Dow did. Approximately 2,500 cases were ultimately identified and assigned to Judge Simpson in this manner. Among the cases on the list was petitioners' case. In 15 cases other than the within case involving the aloe vera program, taxpayers were represented by Randall S. Goulding (Goulding) as counsel of record. Lauren Gore (Gore) was the attorney for respondent initially assigned to handle the cases.

On December 21, 1983, Judge Simpson ordered that 15 cases, including the within case and 14 cases in which Goulding was counsel of record, be among many groups set for hearing in Chicago, Illinois, on January 16, 1984. Accompanying the notice of hearing was a memorandum from Judge Simpson stating the following:

> TO THE PARTIES IN CASES ON THE CALENDAR FOR THE SPECIAL REPORT SESSION OF THE COURT ON JANUARY 16, 1984, IN CHICAGO, ILLINOIS
>
> I have been requested and directed by the Chief Judge of the Tax Court to take charge and manage the cases to be tried in the Chicago area, particularly those involving alleged tax shelters. Let me explain my objectives for this Special Report Session of the Court:
>
> Many cases that appear to be tax shelters have been set for report at this session. Some of these cases will have to be tried; others can be settled on the basis of the decisions in the tried cases. At this

> Special Report Session, I propose to select the cases to be tried and to develop the plans and procedures for bringing those cases to trial at the earliest possible time. I will set a Spring session of the Court for the trial of these cases to commence on April 30, 1984, in Chicago.
>
> At this Special Report Session, I will expect the parties to assist me in identifying the cases that involve similar facts and legal questions and to assist in selecting the most appropriate cases to be tried.

The procedures described in Judge Simpson's memorandum became known to respondent's counsel and to the Court as the "Chicago experiment".

The group of aloe vera cases was called for hearing on January 16, 1984. Petitioners were represented by Steven B. Nagler (Nagler), and respondent was represented by Dow and William C. Sabin, Jr. (Sabin). Nagler stated that he was there also for the other taxpayers in the group of cases at the request of Goulding. Judge Simpson began by asking for an explanation of the related cases. Counsel responded as follows:

MR. SABIN: This involves a research and development promotion in to [sic] two different products. All sixteen participants invested in both -- or I should say, participated in both schemes, and therefore -- and the transactions involved are similar if not identical and therefore, the government has put them both together. One of the investors, Mr. -- and one of the participants, Mr. Drobny, appears to have been the promoter and as a result the government has assessed a fraud penalty against him. The government's position is that any one of these individuals should be tried and that the rest of the cases will follow the issues determined in that trial.

THE COURT: Well, if Drobny involves fraud and the other doesn't, do we try Drobny or --

MR. NAGLER: Well, --

THE COURT: Pardon me?

MR. NAGLER: Your Honor, we would like to try Drobny and one other.

THE COURT: I see.

MR. SABIN: The government has no object to that.

THE COURT: All right. Drobny and one other investor. Is that what you are saying?

MR. NAGLER: That is correct.

MR. SABIN At this time, since Mr. Goulding represents all of the other investors that are not present, it is probably impossible to settle which of the other investors should be tried in addition to Drobny.

MR. NAGLER: Well, but sometime during this week, he will be available, so we will just get together with Mr. Sabin and pick one out and inform --

THE COURT: Arid you will let me know then?

MR. NAGLER: Right.

THE COURT: All right.

MR. NAGLER: I don't know if there is a clean one [single issue], "clean one" in the group, do you?

MR. SABIN: There are several clean ones, Your Honor.

MR. NAGLER: Then one of those will be acceptable.

THE COURT: ALL right. So then we will try two cases here -- two individual cases involving this shelter.

MR. NAGLER: Now, Your Honor, with regard to the April 30th date, Drobny is a new case. I believe the time for even completing pleadings hasn't run yet, has it?

THE COURT: Oh, is that right?

MR. NAGLER: Yesterday?

MR. DOW: No, we have -- the pleadings are completed. The reply has been received.

MR. SABIN: Drobny is the case that has the civil fraud penalty on it, Your Honor.

THE COURT: Yes.

MR. NAGLER: So I don't see any reason why it can not be tried, it is just that [there] has been no discovery undertaken at this point in time.

MR. SABIN: However, informal discovery has commenced and we have arranged meetings with Mr. Nagler as well as with Mr. Goulding next week, and we are fully confident that informal discovery should yield most of the information we need.

THE COURT: Here you are going to have the burden of proof in Drobny --

MR. SABIN: In the fraud.

THE COURT: -- at least as to the fraud, aren't you?

MR. SABIN: Yes, Your Honor.

THE COURT: And are you telling me you think the case can be tried by -- prepared for trial by the April date?

MR. SABIN: Yes, indeed, Your Honor.

THE COURT: And I gather, Mr. Nagler, you are not vigorously disagreeing?

MR. NAGLER: Not at all, Your Honor.

By Order dated January 24, 1984, the within case was set for trial on April 30, 1984. The case of *Lifshitz v. Commissioner*, docket No. 17602-83, in which Goulding represented the taxpayers, was thereafter selected as the other test case.

On April 30, 1984, when the case was called, respondent disclosed to Judge Simpson in open court the pendency of the criminal investigation of petitioner. A joint oral motion for continuance was made by the parties, and the cases were continued to June 25, 1984. In May 1984, district counsel and the district director recommended and decided that the criminal investigation of petitioner would be discontinued. On May 21, 1984, Dow wrote a letter to Nagler, advising Nagler that the criminal investigation had been closed.

Samotny was identified prior to April 30, 1984, as a witness to be called by petitioner and by respondent. He was present in court when the announcement concerning the criminal investigation of petitioner was made. At the request of Samotny's counsel, on May 14, 1984, district counsel wrote a letter confirming a prior oral conversation with Sabin that Samotny was not a target of any investigation but was merely a witness to the transactions at issue in this case. Samotny ultimately testified at trial.

Petitioner also considered calling as witnesses Kamensky and Benjamin Rosenberg (Rosenberg), one of the other investors. In Petitioners' Trial Memorandum filed June 27, 1984, however, neither Kamensky nor Rosenberg was Listed as a witness. The trial commenced on June 27, 1984. On June 28, 1984, Sabin had a telephone conversation with Kamensky, who had been subpoenaed by respondent. As a result of the conversation, Kamensky consulted counsel. Counsel informed him that he should invoke the Fifth Amendment privilege and not testify. Kamensky was called as a witness by respondent on June 29, 1984. On the advice of counsel, he declined to answer any questions concerning the aloe vera research and development programs. The Court inquired into Kamensky's basis for asserting the claim under the circumstances, and the following occurred:

THE WITNESS: Well, there -- there are numerous ones, but two of them are, I was informed yesterday evening by Counsel for Respondent that information that I had was in conflict of information that he had which could, possibly, lead to a perjury indictment and, secondly, because of the fact that we have number of matters before the Tax Court, and speaking to any number of people, including my Counsel, I have been informed that "Regional Counsel is out to get me"; and Your Honor, the -- the fact that they are placing me on the stand for this basis, I think, is indicative of that fact.

THE COURT: Do you have any comment, Mr. Sabin, you would like to make with the result of that statement?

MR. SABIN: For the record, I would Like to state that I never referred to any perjury claim or suspicion in my conversation with Mr. Kamensky last night. It is true that the Government's position is that he knows something about the programs at issue in this trial. We believe he has material information about these programs. That much is clear from the record that has already been established and, indeed, the facts that have been stipulated by the Petitioners and the Government. Furthermore, the Government's position is that this whole program was fraudulent, and I am forced to concur with Mr. Kamensky's position that he may be in some risk. Beyond that, I have no further comment.

MR. SABIN: No, there is one other comment. He -- to the best of our knowledge -- well, I would say, categorically, that he is not under any criminal investigation at this time or does one appear imminent, and this is the result of a telephone conversation with the Deputy Director, Harold Cook, as of yesterday afternoon. He is a Deputy Regional Counsel for criminal tax.

After argument by Kamensky's counsel and Dow, the Court sustained Kamensky's claim and excused him from further testimony.

Rosenberg was not listed as a witness by any party prior to trial. Rosenberg was an accountant as well as an investor in the aloe vera program. He had recommended the investment to some of his clients. Goulding had filed a petition on behalf of Rosenberg with respect to Rosenberg's investment in the aloe vera programs. Rosenberg's personal return was audited by Feinglass. Prior to trial of the within case, Feinglass came to Rosenberg's office to discuss the possibility of a settlement by which he would be allowed his "out-of-pocket" payments as a deduction. When petitioner called Rosenberg and requested that he testify during trial of the within case, Rosenberg had already decided not to testify. Rosenberg told petitioner that he did not wish to testify against the IRS because he feared repercussions.

In the Opinion filed June 26, 1986, 86 T.C. 1326, the Court sustained respondent's determination, including the additions to tax for fraud against petitioners. The Opinion, authored by Judge Simpson, discussed petitioner's background, his claimed reliance on Kamensky, and the specific objective facts that: clearly and convincingly indicates that Mr. Drobny knew that some or all of the research and experimental expenditures arising from the programs were not deductible and that he intentionally reported losses resulting from such claimed deductions on his 1979 income tax return, resulting in a fraudulent underpayment of tax. Petitioner did not file a timely notice of appeal from the decision. Pursuant to sections 7481(a)(1) and 7483, I.R.C., the decision became final on September 24, 1986.

In July 1993, Feinglass told petitioner that the criminal investigation referral would not have been made if petitioner had agreed to the deficiency in his own case and that Feinglass' second objective for the referral was to determine petitioners involvement with Goulding. Thereafter, petitioner decided to bring the pending motion, which was filed February 18, 1994.

Discussion

The context of this case requires awareness of the circumstances created by the large number of tax shelter cases arising during the late 1970's and early 1980's as a result of tax shelter programs such as those promoted by petitioner. The large number of cases led to specialized response by the IRS, by the Court, and by Congress. The trends were summarized in H. Rept. 98-86l, at 985-986 (1984), 1984-3 C.B. (Vol. 2) 239-240, as follows:

> The conferees note that a number of the provisions of recent legislation have been designed, in whole or in part, to deal with the Tax Court backlog. Examples of these provisions are the increased damages assessable for instituting or maintaining Tax

Court proceedings primarily for delay or that are frivolous or groundless (sec. 6673), the adjustment of interest rates (sec. 6621), the valuation overstatement and substantial understatement penalties (secs. 6659 and 6661), and the tax straddle rules (secs. 1092 and 1256). Additionally, the conference agreement did not follow the provision of the House bill permitting certified public accountants and enrolled agents to represent a taxpayer in a small tax case because the Tax Court stated that permitting this would jeopardize the integrity of the small tax case process, which is working well.

The conferees believe that, with this amendment, the Congress has given the Tax Court sufficient tools to manage its docket, and that the responsibility for effectively managing that docket and reducing the backlog now lies with the Tax Court. The positive response that the Court has made to several recent GAO recommendations is encouraging and the conferees expect the Court to implement swiftly these and other appropriate management initiatives. The conferees also note favorably the steps the Court has begun to take in consolidating similar tax shelter cases and dispensing with lengthy opinions in routine tax protestor cases. The Court should take further action in these two areas, as well as to assert, without hesitancy in appropriate instances, the penalties that the Congress has provided.

> The Internal Revenue Service also has significant responsibilities in reducing the Tax Court backlog. The Service's settlement policy should be fair and flexible, and only appropriate cases should be litigated. Although in the recent past the Service has offered to settle many tax shelter cases by permitting taxpayers to deduct out of pocket expenses, the Service no longer routinely offers this as a settlement. This is a constructive change in policy, in that a taxpayer should not expect to be able to deduct out of pocket expenses regardless of the circumstances of his case. The Service should assert, without hesitancy in appropriate circumstances, the penalties that the Congress has provided. In particular, the negligence and fraud penalties are not currently being applied in a large number of cases where their application is fully justified. The conferees note with approval the steps the Service has recently taken to eliminate the backlog in the Appeals Division.

The Tax Court Reports, including specifically the volume in which the Court's 1986 Opinion in this case appears, reflect the large number of Tax Court cases tried and submitted to the Court during that era.

Reported cases also reflect Goulding's continuing troubles with the U.S. Government and his attempts to blame many of his problems on Feinglass. See *Goulding v. United States*, 957 F.2d 1420 (7th Cir. 1992); *Goulding v. Feinglass*, 811 F.2d 1099 (7th Cir. 1987); *Goulding v. Commissioner*, T.C. Memo. 1988-212, aff'd. without published opinion 928 F.2d 1135 (7th Cir. 1991). Petitioner also has had continuing controversy with the IRS. See

Adler & Drobny, Ltd. v. United States, 9 F.3d 627 (7th Cir. 1993). The crux of petitioners' present complaint is stated in their brief as follows:

> Throughout the course of their preparation for the trial of *Drobny v. Commissioner*, Respondent's attorneys and agents engaged in a knowing and deliberate plan to prevent Petitioners from fully and fairly defending themselves at trial. In furtherance of their plan, Respondent's attorneys and agents (1) manipulated facts, circumstances and people to the and of intimidating the Petitioners' critical witness into not testifying; (2) intimidated yet another potential witness on behalf of Petitioners into not testifying; arid (3) violated audit and investigation procedures in an effort to force Petitioners to settle, and when that failed, manipulated facts and circumstances to cause an unfounded -- and ultimately entirety dormant, criminal investigation of Mr. Drobny to be commenced.

Petitioners contend that the conduct complained of constituted a fraud on the Court and that the decision, otherwise final, should be vacated in accordance with *Toscano v. Commissioner*, 441 F.2d 930 (9th Cir. 1971), revd. and recommend 52 T.C. 295 (1969); and *Kenner v. Commissioner*, 387 F.2d 689 (7th Cir. 1968), in which a taxpayer sought to vacate 318 F.2d 632 (7th Cir. 1963), aff'g. T.C. Memo 1961-37.

Because of the passage of time, each of the witnesses at the hearing in November 1994, other than petitioner, indicated some Lack of recollection of the sequence of events and specific conversations that petitioner alleged to have occurred. Feinglass denied statements that had been attributed to him by IRS personnel investigating complaints brought against him by Goulding. Petitioners caused a writ of habeas corpus to be issued by the Court to secure the appearance of Goulding, who was imprisoned as a result of his criminal conviction; after he appeared, petitioners decided not to call Goulding as a witness. Rosenberg did not recall specific statements attributed to him by petitioner. Neither Nagler nor respondents attorneys involved in the case recalled specific sequences of events, notwithstanding the written record available to all of them.

Some of the events that petitioner now suggests were unfair to him, such as expedited trial of his case, were specifically suggested or agreed to by Nagler, as appears from the transcript quoted above. Although petitioner suggests that the initial contact between Dow and Judge Simpson was somehow designed to prejudice his rights, there is no indication that Judge Simpson had any information about this specific case prior to the hearing in January 1984, when the parties explained the circumstances to him.

Petitioners have neither shown nor cited any specific examples of false statements, willful concealment, or other misrepresentations by respondents counsel or other agents. Although they refer to a plan or conspiracy, they have not cited any violations of taw or ethical restrictions by respondents counsel. They have not even alluded to the pertinent Model Rules of Professional Conduct (1994). For example, Rules 3.4 provides:

> A lawyer shall not:
> (a) unlawfully obstruct another party's access to evidence or unlawfully alter, destroy or conceal a document or other material having potential evidentiary value. A lawyer shall not counsel or assist another person to do any such act;
>
> (b) falsify evidence, counsel or assist a witness to testify falsely, or offer an inducement to a witness that is prohibited by law;
>
> (c) knowingly disobey an obligation under the

rules of a tribunal except for an open refusal based on an assertion that valid obligation exists;

(d) in pretrial procedure, make a frivolous discovery request or fail to make reasonably diligent effort to comply with a legally proper discovery request by an opposing party;

(e) in trial, allude to any matter that the lawyer does not reasonably believe is relevant or that will not be supported by admissible evidence, assert personal knowledge of facts in issue except when testifying as a witness, or state a personal opinion as to the justness of a cause, the credibility of a witness, the culpability of a civil litigant or the guilt or innocence of an accused; or

(f) request a person other than a client to refrain from voluntarily giving relevant information to another party unless:

> (1) the person is a relative or an employee or other agent of a client; and
>
> (2) the lawyer reasonably believes that the person's interests will not be adversely affected by refraining from giving such information.

Rules 4.2. provides:

> In representing a client, a lawyer shall not communicate about the subject of the representation with a party the lawyer knows to be represented by another lawyer in the matter, unless the lawyer has the consent of the other lawyer or is authorized by Law to do so.

We have considered the evidence with regard to those rules, which are applicable to counsel appearing in cases before us. See Rule 201(a), Tax Court Rules of Practice and Procedure.

Petitioners specifically complain that they were "prevented from offering the testimony of two critical witnesses"---Kamensky and Rosenberg. Neither had been identified as a witness in Petitioners' Trial Memorandum. Both witnesses were well known to petitioners and their counsel prior to trial. At the hearing on the pending motion, Rosenberg testified that, before he was contacted by petitioner about testifying in this case, he decided that he did not wish to testify against the IRS. He did not recall telling petitioner that he declined to testify because of implied threats by Feinglass. Petitioners contend that Feinglass offered a settlement to Rosenberg if he would testify that the investments were a sham. Rosenberg testified at the hearing on the pending motion that he refused to do that on two separate occasions. If Rosenberg had testified at the trial in 1984 that the investments were a sham, petitioners would have a stronger claim now, but he did not testify at that trial at all. Rosenberg's current testimony does not support petitioners contentions.

Petitioners allege a pattern in which respondent's counsel offered to settle with Goulding's clients in various tax shelter cases only if those clients would fire Goulding. They contend that Sabin and Gore directed Feinglass to make such an offer to Rosenberg. Feinglass has made inconsistent statements in that regard. To support their allegations, petitioners offered evidence that a similar tactic was employed by Gore in relation to an unrelated group of cases involving Goulding. Respondent contends, and the Court agrees, that evidence of the other and later context is not admissible under Rule 404 of the Federal Rules of Evidence. Assuming, however, that respondent's counsel attempted to deal with Goulding's clients in violation of Rule 4.2, Model Rules of Professional Conduct, such conduct was not directed at petitioner's right to a fair trial. Even if the proffered evidence were considered, therefore, it would not persuade us that such conduct constituted a fraud on the Court in this case.

Petitioners contend that "The circumstances surrounding the criminal fraud referral of Mr. Drobny were inexcusable." They imply a violation of the Internal Revenue Manual. Again, they have not shown any false statements or concealment relating to the fraud referral. At most, respondents agents were taking inconsistent actions, none of which was patently unreasonable in view of the circumstances of the case. We cannot infer a fraudulent plan or conspiracy from these facts.

Many of the matters that petitioners complain of occurred in open court. They complain, for example, that pendency of the criminal investigation of petitioner was announced in open court in front of Samotny, prior to Samotny's, testimony. Petitioners have not indicated how, if at all, Samotny's testimony was affected by truthful statements made in open court in his presence. They contend that Kamensky should have been given the "same assurances" that had been given to Samotny. Neither the failure to give assurances to Kamensky nor his assertion of his privilege against self-incrimination is extraordinary or unreasonable in these circumstances.

Petitioner asserts as a fact that, in April 1984, Nagler served a subpoena on Kamensky and that petitioners' primary defense to the civil fraud claim was reliance upon Kamensky. They claim now that Kamensky was a crucial witness. Yet they did not list Kamensky in their trial memorandum because they intended to call Kamensky only in rebuttal to respondent's evidence on the civil fraud penalty. During the hearing in June 1984, Kamensky's counsel complained that respondent had wrongfully caused Kamensky to come to Court and assert his Fifth Amendment privilege. Kamensky gave his view of his conversation with Sabin, and Sabin gave his view. Neither the communications nor the basis for the assertion of the privilege were concealed from nor misrepresented to petitioners or to the Court.

In *Kenner v. Commissioner*, 387 F.2d at 691 (7th Cir. 1968), the Court of Appeals for the Seventh Circuit stated:

> there is a heavy burden both of particularized pleading and of proof upon the one who seeks to impeach an order or decree of a court. "There must be an offer to prove specific facts which will pretty plainly impugn the official record." *United States ex rel. Accardi v. Shaughnessy*, 206 F.2d 897, 904 (2d Cir. 1953). It "is necessary to show an unconscionable plan or scheme which is designed to improperly influence the court in its decision." *England v. Doyle*, 281 F.2d 304, 309 (9th Cir. 1953).
> "Fraud upon the court should, we believe, embrace only that species of fraud which does, or attempts to, defile the court itself, or is a fraud perpetrated by officers of the court so that the judicial machinery cannot perform in the usual manner its impartial task of adjudging cases that are presented for adjudication." [7 Moores Federal Practice, 2d ed. p.512, par.60.23.] [Fn. refs. omtted.]

Discussing the specific allegations in that case, the court commented that "Even assuming, however, that the agents were hostile or had an attitude of unfairness tovard Dr. Kenner, the petition (of Dr. Kenner) leaves us completely in the dark as to how the agent fraudulently induced the court to decide against Dr. Kenner." *Kenner v. Commissioner*, 387 F.2d at 692. Similarly in this case, petitioners have not persuaded us that any of the matters they complain of were intended to or did affect the decision of the Court in this case.

In his Opinion in this case, Judge Simpson considered and rejected petitioners' claim of reliance on others, specifically Kamensky. Petitioners supposition that "Perhaps Kamensky would have persuaded Judge Simpson that Petitioners' deduction was legitimate or that a fraud penalty was not warranted, or both ignores the analysis in the Court's Opinion." Kamensky no doubt would have attempted to justify his involvement in the tax shelter promotions, but this testimony would have been cumulative and subject to the same reasons for rejecting it that Judge Simpson gave for rejecting petitioner's testimony. Adding the subjective opinions of other interested persons in the litigation would have not changed the objective facts on which the Opinion is based.

To the extent that petitioners believe that they were unfairly denied "a cash-out-of-pocket" settlement because of a vendetta by Feinglass against Goulding, they would be seeking something that this Court has consistently denied taxpayers. See *Chao v. Commissioner*, 92 T.C. 1141, 1144 (1989), and cases cited therein. Petitioners have cited no case in which comparable facts have resulted in a different decision. Thus the decision here was not obtained by the conduct complained of, whether or not it was wrongful.

Petitioners argue that "In order to have a decision overturned, it is not necessary that the court find that the prior decision was obtained as a direct result of fraud on the court nor that the court would have reached a different result had the fraud not occurred" Petitioners' argument cannot be reconciled with the language of Kenner or similar cases. The seminal case of *Hazel-Atlas Glass Co. v. Hartford-Empire Co.*, 322 U.S. 238 (1944), involved specific fabrication by an attorney for one of the parties, which was relied on in the decision of the court. See *Wilkin v. Sunbeam*

Corp., 466 F.2d 714, 717 (10th Cir. 1972). Other courts have referred to "an unconscionable plan or scheme which is designed to improperly influence the court in its decision." *England v. Doyle*, 281 F.2d 304, 309 (9th Cir. 1960) (quoting *Kenner v. Commissioner*, supra at 691). This language implies direct causation. See also *Chao v. Commissioner*, supra. To justify setting aside a decision for fraud, a party must show more than conduct of counsel during settlement negotiations or during trial that is within bounds of aggressive advocacy *on* behalf of a client. See *Kerwit Mod. Products, Inc. v. N. & H. Instruments, Inc.*, 616 F.2d 833, 837 (5th Cir. 1980); *Wilkin v. Sunbeam Corp.*, supra; *Kupferman v. Consol. Research & Manufacturing Corp.*, 459 F.2d 1072 (2d Cir. 1972). If ethical rules have been violated, appropriate referrals to bar associations may be by the injured party, other attorneys, or the Court. They are not sufficient cause to vacate a decision that has become final.

In summary, we cannot conclude that respondent was guilty of misrepresentation or concealment or that the Court was in any way deceived as to the facts m which it based its decision. We are not persuaded that the conduct of respondent's attorneys or agents was designed to deny a fair trial to petitioner. Whether or not the actions taken were wise or appropriate, they were a response to the facts of the tax shelter promotions as perceived by respondent. Petitioners have not satisfied their burden of proving fraud on the Court.

An appropriate order will be issued denying petitioners' motion for leave to file motion to vacate.

Sheldon Drobny and Anita Drobny v. Commissioner, Louis

Lifshitz and Ruth Lifshitz v. Commissioner

Docket Nos. 16985 83, 17602 83, 86 TC 1326, Filed June 26, 1986 (Appealable, barring stipulation to the contrary, to CA 7. CCH.] [Code Secs. 174 and 6653)

Howard L. Stone, Steven B. Nagler, David A. McGuire, and Fred A. Bibeau, for the petitioners in docket No. 16985 83. Randall S. Goulding, for the petitioners in docket No. 17602 83. Lauren W. Gore and William C. Sabin, Jr., for the respondent.

SIMPSON, Judge:

The Commissioner determined the following deficiencies in, and addition to, the petitioners' Federal income taxes for 1979:

Petitioners	Deficiency	I.R.C. 1954[1] Addition to Tax Sec. 6653(b)
Sheldon and Anita Drobny......	$10,877	$5,439
Louis and Ruth Lifshitz........	32,052	

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect during 1979, unless otherwise indicated.

The issues for decision are: (1) Whether the petitioners are entitled to deductions for their proportionate share of losses resulting from alleged research and experimental expenditures by a joint venture and a partnership in 1979; and (2) whether Mr. Drobny is liable for the addition to tax for fraud under section 6653(b) for 1979.

Findings of Fact

Some of the facts have been stipulated, and those facts are so found.

The petitioners, Sheldon and Anita Drobny, husband and wife, maintained their legal residence in Highland Park, Ill., at the time their petition was filed. They filed their joint Federal income tax return for 1979 with the Internal Revenue Service Center at Kansas City, Mo. The petitioners, Louis and Ruth Lifshitz, husband and wife, maintained their legal residence in Wilmette, Ill., at the time their petition was filed in this case. Their joint return for 1979 was filed with the Internal Revenue Service.

Twenty-two investors,[2] including Messrs. Drobny and Lifshitz, participated in two research and development investment programs, Farm Animal Product Venture (FAP) and AloEase Partnership (AloEase). Mr. Lifshitz purchased one unit, a one-twentieth interest, in each program; and Mr. Drobny purchased one-half a unit, a one-fortieth interest, in each program. FAP was a joint venture formed for the purpose of developing and marketing Pork Pardner, a medicine to be fed to farm animals, particularly hogs, for the prevention and treatment of various diseases that decrease the size of litters and adversely affect the health of small pigs. AloEase was formed for the purpose of acquiring, developing, and marketing a treatment to soothe aching or burning human eyes

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[2] The owners of an interest in the programs who are husband and wife are considered one investor for purposes of this opinion.

(AloEase product). The investors were treated as general partners in AloEase and were treated as owning FAP as tenants in common. The profits, losses, credits, and cash flow in each program were shared in relation to the investors' ownership interests.

Both Pork Pardner and the AloEase product were to contain aloe vera. Aloe vera is an extract from the Aloe Barbidensisi plant, of which there are approximately 270 species. Because it is thought to have medicinal, pain-killing, and healing properties, it is used in a wide range of products for humans and animals.

Isle of Aloe, Inc. (Isle), was incorporated in 1967 for the purposes of conducting research, development, and marketing of aloe vera based products. Between 1967 and 1984, Isle developed and marketed at least 35 such products. Robert White was one of the original incorporators of Isle and its president and majority shareholder in 1979 and 1980. In June 1979, he contacted Marvin Kamensky to secure funds to conduct the research, development, and marketing of Pork Pardner and the AloEase product. At the end of 1979, Isle had a $668,315 deficit in retained earnings, and in March 1981, it filed for bankruptcy under Chapter 11.

Mr. Kamensky was a partner in the law firm of Kamensky & Landan (the law firm).[3] He arranged research and development tax shelters and was known in Chicago as an attorney with experience in the formation of such tax shelters. He directed and controlled the creation of all of the research and development programs at issue, the creation of all the entities involved in such program (except for Isle), and the material relationships between such entities.

Marc Z. Samotny was an associate with the law firm during 1979 and early 1980. Under the direction of Mr. Kamensky, he prepared all of the documents involved in the transactions which were a part of the programs.

Sheldon Drobny was an Internal Revenue Service agent from

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[3] The law firm is now known as Kamensky & Rubinstein.

1967 through 1971 and has been a Certified Public Accountant in private practice since 1971. He received the Elijah Watts Sells Award from the American Institute of Certified Public Accountants for being in the top 27 out of 19,000 people who took the CPA exam. He taught income tax accounting for a CPA review course and was an instructor for the IRS while working there, teaching basic and advanced agent training courses in the area of taxation. At all relevant times, he was a partner with Louis Adler in Adler and Drobny, Ltd. (the accounting firm). In December 1978, Messrs. Adler and Drobny promoted four research and development investment programs with a total purchase price of $1,786,000. They promoted a $1,745,000 real estate investment program in December 1977.

In November 1979, Mr. Drobny was informed by Mr. Kamensky of the Pork Pardner and AloEase product programs. Because the necessary transactions had to be completed in December, Mr. Drobny was not initially interested; however, he agreed to review information concerning both programs. In a letter dated November 28, 1979, Mr. Samotny sent Mr. Drobny an outline of the transactions for the two programs, a chart showing the flow of the funds, and a statement of the cash to be invested and the tax benefits to be derived therefrom.

On November 30, 1979, Mr. Samotny wrote to Mr. Drobny again to provide him with a "sales kit" which contained a more detailed explanation of the FAP and AloEase programs and their tax consequences. In part, the letter stated:

> The individual investors will compensate Isle of Aloe in an amount equal to $800,000.00 (comprised of $160,000 in cash and $640,000 in the form of bank loans) for the research and development of the subject animal product. Upon completion of the research and development, the individual investors, acting as tenants-in-common will apply for a patent on the animal product. It is currently contemplated that such

application will be made by Isle of Aloe.

Isle of Aloe, Inc. will subcontract with Swain's corporation in order that it may provide the necessary research and development for the animal product. Isle of Aloe will pay Swain's corporation $750,000.00 pursuant to the subcontract for the research and development. In turn, Swain's corporation will pay to the investors on or about January 15, 1980 an advance minimum royalty equal to $750,000.00 attendant the right to commercially exploit the animal product.

Each individual investor will also be required to enter into a partnership for the exploitation of a second product. It is currently contemplated that this product will be an Isle of Aloe product to be used as an eye wash. The partnership will acquire all of Isle of Aloe's right, title and interest in and to the eye wash product. Subsequently, the partnership will enter into a research and development agreement with Isle of Aloe whereby the partnership will pay to Isle of Aloe $320,000.00 ($60,000.00 cash and $260,000.00 in the form of bank loans) to perform research and development on the product.

Isle of Aloe will, upon receipt of the $320,000.00, make a loan to a corporation to be owned and controlled by Paula Larson in the amount of $150,000.00. This corporation will in turn pay to the partnership $150,000.00 in the form of option money to have the right to commercially exploit the eye wash product. In order to exercise its option the corporation controlled by Paula Larson will also be required to pay $300,000.00 upon exercise of the option and in addition will pay the partnership group a royalty

> presently contemplated to be eight percent of gross sales. As you are aware, the grant of the option money to the partnership is a nontaxable event until such time as either the option is exercised or the option period lapses.
>
> In the materials sent by Mr. Samotny to Mr. Drobny on November 30, 1979, one sentence was devoted to describing each product, and tax and cash analyses were included. It was indicated that a purchaser of a unit would contribute $11,000 in cash, that he would borrow $45,000, and that he would claim a deduction for the entire $56,000. The 1979 net tax benefit from the programs was expected to be $17,000 per unit for investors in the 50-percent tax bracket and $28,200 for those in the 70-percent bracket. The net total tax benefit from the programs was listed as $9,500 for investors in the 50-percent bracket and $17,700 for those in the 70-percent bracket. The large 1979 benefit would arise from the investors' deduction of losses resulting from research and experimental payments to Isle of $1,120,000. In 1980, the receipt of an option payment was listed as non-taxable, but a $750,000 advance minimum royalty was expected to be taxable at the long-term capital gain rate, thereby decreasing the net tax benefit of the programs.

Shortly after receiving such letter, Messrs. Samotny and Drobny discussed the similarities between the two programs at issue and an earlier one of Mr. Kamensky's which Mr. Drobny had reviewed in August 1979; the three programs were almost identical in structure, form, and tax effects. Mr. Drobny then began soliciting investors from among his clients and associates; at least 7 of the 22 investors were his clients.

Each investment program was described and offered to the investors in its own private placement memorandum. Such memorandums require that each investor have sufficient wealth or income to enable him to withstand the loss of his investment without undue hardship. At least 10 pages in each memorandum are dedicated to explaining the tax ramifications of the program, including the deductibility of research and experimental expenditures. It is clearly stated that prior projects seeking similar tax objectives have been "set aside" in full or in part by the IRS. There is a warning that an audit by the IRS may lead to an increase in an investor's tax liability.

Messrs. Adler and Drobny are identified as the promoters of the programs and as having previously promoted research and development programs which were unsuccessful. The accounting firm is described as one "which specializes in corporate, individual, trust and partnership financial and tax consultation."

The law firm is identified as having been retained by the promoters as special counsel with respect to certain tax aspects of the programs. Following a statement that the law firm had not independently verified any of the information in the memorandum relative to any of the parties involved, each memorandum has a statement in capital letters encouraging investors to seek independent counsel concerning the merits of the program and its tax consequences. Elsewhere, it is stated that there will be no independent management for the investors and no managing investor, and that the lack thereof might make it difficult for the investors, as a group, to enforce their rights under the agreements.

The memorandums state that the law firm is to receive $17,500 for each program from Isle for drafting documents and providing tax advice and that the accounting firm is to receive $15,000 per program from Isle for accounting services. In fact, although such $30,000 was paid to the accounting firm, Mr. Drobny never examined the financial records of any corporation involved in the programs, nor did the accounting firm prepare the tax returns for any such corporation.

The memorandums contain general statements, attributed to Isle, about the marketability of the products, but no market survey data. There is no evidence that any market study was ever made. Income projections refer only to the option payment and the advance minimum royalty to be received in 1980. Visine and Murine are identified as the primary competition for the AloEase product, while American Cyanamid and Pfizer products are listed as Pork Pardner's competition. The memorandums state that each product is a conceptual idea which has not, and perhaps will not, be developed, but Isle will attempt to deliver such products by September 30, 1980. Cash and tax benefit analyses are presented for 1979 and 1980. The transactions involved in each program are described in detail in its memorandum, except that there is no mention of any loans.

Two corporations were created in conjunction with the programs, Farm Animal Laboratories, Inc. (FAL), and Aloe Research Laboratories, Inc. (ARL). The articles of incorporation for each were prepared by the law firm. Such articles for ARL were filed with the Secretary of State for Illinois on December 7, 1979. In the earlier letters, such corporation was identified as one controlled by Paula Larson, but she was not listed as an officer or director of such corporation and never acted for it. Gary Swain and Paula Larson were listed as the directors of FAL, which took the place of a corporation referred to as "Swain's" corporation in the earlier letters. on December 17, 1979, such articles for FAL were filed with the Secretary of State for Iowa.

In letters dated December 14, 1979, the law firm provided additional comments to the accounting firm concerning possible tax consequences of the programs. Concerning the possibility that investors might be denied any deductions for expenditures by AloEase because it was an activity entered into solely for tax avoidance, the law firm included the following:

> Based upon the foregoing, it is conceivable that the Service could take the position that this transaction is a sham for tax avoidance purposes only, and

> presuming arguendo that the Service could ultimately prevail on this issue, then the Partnership's deductions in 1979 could be limited to the cash which was actually advanced for the research and development ($320,000.00 less the option payment of $150,000.00).

The rule that the substance of a transaction, rather than [sic] its mere form, controls tax liability, is one of the most widely accepted principles under our form of taxation. Basically, "form" is a pattern or scheme, the aspect under which a thing appears as distinguished from "substance" that which underlies all outward manifestations the realty [sic] itself. In this respect, the form of the transaction may be disregarded if it has no purposes other than reduction of taxes. *Gregory v. Helvering*, 298 U.S. 465 (1935). Furthermore, if a transaction is not at arm's length, the question of substance versus form is often raised in an attempt to disregard the apparent tax results. Although no cases exist directly on this point, the Service has been successful in many cases involving controlled or related taxpayers. *Crown Cork International Corp.*, 4 T.C. 19, aff'd. 149 Fed [2d] 968 (4th Cir.; 1945); *Limmericks, Inc.* , 7 T.C. 1129, aff'd. 165 F.2d. 483 (5th Cir.; 1948); *Central Cuba Sugar Co.*, 16 T.C. 882, aff'd. 198 F.2d 214 (2d Cir.; 1952).

In the *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir.; 1976), the Court held that the failure on the part of the purchaser of real estate to demonstrate that the purchase price of the property was at least approximately equivalent to the fair market value of same resulted in the exclusion of the entire non-recourse obligation from the tax basis of the property for depreciation purposes and the disallowance of interest on the non-recourse obligation. similarly, in Revenue Ruling 77-110, 1977-1 CB 16, the Service held that the liability on a non-recourse interest bearing note given as part of the purchase price of film distribution rights, whose value could not be shown to approximate the amount of the note, may not be included in the basis of the rights for depreciation purposes. Accordingly, if the Service were to challenge the Partnership's deduction under Code Section 174 on (a) similar theory in the light of all of the facts and circumstances, and the Partnership was not able to show that the amounts paid to Isle for research and development were approximately equal to their value, then it is possible that the Partnership could be denied a deduction for a portion of the amounts paid to Isle.

Notwithstanding the foregoing, the Courts, including the Supreme Court, have recognized that a taxpayer may legally reduce his tax liability through structuring a transaction. *U.S. v. Isham*, 17 Wall 496 (1873) and *Bullen v. Wisconsin*, 240 U.S. 625 (1916). Accordingly, this area appears to remain a factual one, in which each case must be reviewed separately to determine the realities involved. Similar comments appeared in the letter concerning FAP.

In December 1979, Mr. Kamensky requested that the Harris Trust and Savings Bank (the bank) make loans to each investor for $45,000 per unit of investment in both programs. He assured the bank's loan officer that the loans would be repaid within 3 weeks and stated that they were part of a "tax shelter deal." He also explained to the bank officer the proposed transactions, and under the arrangement the money would not, in fact, leave the bank. The loan officer agreed to make the loans only upon Mr. Kamensky's personal assurance that the loans would promptly be repaid. However, Mr. Kamensky did not guarantee such loans, and the investors had to qualify for them.

In a letter dated December 17, 1979, to Messrs. Adler and Drobny, Mr. Samotny described all of the paper work involved in financing the programs. In order to obtain funds from the bank, a completed personal financial statement, "certificate re business loan," and an unsecured note form had to be signed by each investor. In December 1979, each investor holding one unit in each of the programs would prepare three personal checks: a check for $40,000 to Isle for research and development of Pork Pardner; one for $16,000 to AloEase, as a capital contribution; and another, dated January 15, 1980, for $45,600 to the bank. As stated in the letter, each investor's check to the bank was a loan repayment check comprising $45,000 in principal and $600 in interest. Mr. Drobny was responsible for the collection of such checks and the other papers.

A closing meeting for the transactions involved in the two projects (the meeting) was held at the law firm on December 26, 1979. Present at such meeting were Ms. Larson; Messrs. Drobny, Kamensky, Samotny, Swain, and White; and Charles Marker. Mr. Drobny signed all relevant documents presented at such meeting as the representative of AloEase. At the meeting, Mr. White signed all relevant documents on behalf of Isle. Among such documents were the research and development agreements between FAP and Isle and between AloEase and Isle. The contract with FAP called for Isle to receive $800,000 for research and development activities concerning Pork Pardner and to deliver the results thereof on September 30, 1980. Isle was to be paid $320,000 for such services in connection with the AloEase product.

Ms. Larson was the developer of Pork Pardner. During 1978 and 1979, she conducted field tests on Pork Pardner at the direction of Mr. White. She has been a secretary to the Dean of Pharmacy at Creighton University and a supervisor for a farm management corporation; she has had no training in research and does not have a college degree. At Mr. White's request, coupled with the promise of at least $25,000 to continue research, she attended the meeting. As the secretary of FAL, she signed several documents at the meeting; she did not have an opportunity to read such documents before signing them.

At the meeting, Ms. Larson signed an acquisition agreement between herself and Stoma Laboratories, Inc. (Stoma), a corporation Mr. Drobny had promoted in 1978. She received all of Stoma's rights in the unpatented Pork Pardner in exchange for $10 and 2 percent of gross sales in excess of $3,000,000. At the same time, she executed an acquisition agreement transferring her rights in the product to FAP in return for $10 and a royalty fee of 6 percent of the gross sales above $3,000,000.

Mr. Swain has a college degree in animal science and was a salesman of farm products at all relevant times. At Mr. White's request, he attended the meeting. Although he was nominally the president of FAL, he was not permitted to read any of the numerous documents signed by him at the meeting.

Mr. Swain and Ms. Larson signed the research and development agreement between Isle and FAL and the exclusive license agreement between FAL and FAP. Under such research agreement, Isle entered into a subcontract with FAL to perform the research and development of Pork Pardner; such product was to be delivered to Isle by September 15, 1981. The license agreement provided FAL with the exclusive right to manufacture, market, and exploit the product. In return, FAL promised to pay FAP a license fee equal to 25 percent of gross sales of the product up to $3,000,000 and 12 percent on sales in excess of $3,000,000. FAL was to make an advanced royalty payment of $750,000 on January 15, 1980.

Mr. Marker is a retired pharmacist who has worked in a series of drug stores and pharmacies since 1949. While working as a pharmacist, he started a manufacturing laboratory, which primarily manufactured aloe-based products. Such endeavor was not very successful, requiring funding from his pharmacy wages. During 1979, he worked on developing the AloEase product for Mr. White, who requested that he attend the meeting.

At the meeting, Mr. Marker signed numerous documents at the direction of Messrs. White and Drobny. Among the papers signed by him was the option agreement, under which AloEase granted ARL the exclusive option to enter into an exclusive license agreement for the AloEase product in return for $150,000. The option may be exercised by the payment of $300,000 to AloEase prior to noon on December 31, 1989. No research and development agreement between ARL and Isle was ever executed. Mr. Marker did not have the opportunity to read any of the documents signed by him, and he was told that the day's activities would result in $200,000 for his research. Additionally, he was informed that he was the president of ARL.

Mr. Marker's signature was the only authorized one for the ARL checking account, which was opened at the bank on December 13, 1979. On the same day, a checking account in the name of FAL was opened at the bank, with Ms. Larson and Mr. Swain as authorized signatories. Two weeks later, Mr. Drobny opened a checking account at the bank for AloEase. His was the sole authorized signature on such account. Mr. White opened a checking account in the name of Isle at the bank on December 27, 1979.

On December 27, 1979, the bank made the requested loans to the investors and, in return, received a promissory note from each investor designating January 16, 1980, as the due date. Also on December 27, 1979, the proceeds of the bank loans were credited to the Isle account at the bank, $640,000, and to the AloEase account at the bank, $260,000. Such proceeds were disbursed without any authorization by the investors. As anticipated, $220,000 in cash was collected from the investors; $160,000 was deposited in the Isle account and $60,000 in the AloEase account. On December 27, 1979, $320,000 was transferred by debit memo from the AloEase account to the Isle account. on the same day, the bank debited the Isle account $750,000 pursuant to a check drawn by Mr. White and payable to FAL, and $150,000 pursuant to a check drawn by Mr. White and payable to ARL. Neither Ms. Larson nor Mr. Swain was aware of the checks to FAL; nor was Mr. Marker aware that ARL had received a check from Isle. On or after December 27, 1979, the bank debited the Isle account $35,000 pursuant to two checks payable to the law firm, $30,000 arising from two checks payable to the accounting firm, $10,000 to a second law firm, and $144,100 pursuant to a check payable to Isle; all such checks were drawn by Mr. White.

On December 27, 1979, the bank debited the FAL account $750,000 pursuant to the instructions of Mr. Kamensky. Such funds were applied to the purchase of commercial paper in the name of FAL. The $750,000 purchase was without the knowing authorization of Ms. Larson or Mr. Swain.

A loan from Isle to ARL was part of the series of transactions involved in the program for the development of the AloEase product; a judgment note evidencing the loan was signed by Mr. Marker without his knowledge of its contents or of the loan. Such loan was made by means of the $150,000 check from Isle which was deposited on December 27, 1979, in the ARL account at the bank. The loan was not described in the private placement memorandum relating to the program. Repayment of such loan has not been made and has not been sought.

Pursuant to the instructions of Mr. Kamensky, the bank, on December 27, 1979, debited the ARL account $150,000 and purchased commercial paper in the name of ARL from the bank for such amount. The purchase of such commercial paper was made without the authorization of Mr. Marker.

On January 14, 1980, the FAL and ARL commercial paper matured. The FAL account was credited $755,020.88, principal and interest. The ARL account was credited $151,004.18, principal and interest. On the same day, $750,000 was debited from the FAL account and $150,000 was debited from the ARL account. Mr. Marker was not aware of the credit to the ARL account, and at trial, could not recall the debit to such account. Pursuant to the directions of Mr. Kamensky, such funds were combined and distributed to the 22 investors in the form of cashiers' checks payable to each of the investors in the amount of his bank loan. Such checks were deposited in the checking accounts of the investors by Mr. Drobny, and the proceeds were used to pay the principal of such loans. At the direction of Mr. Kamensky, the interest earned on the commercial paper was distributed to the investors by means of checks signed by Ms. Larson. From January 24 to February 19, 1980, Mr. Samotny forwarded to the bank investors' checks in payment of the interest due on their loans.

An outline of the research and development necessary to develop

Pork Pardner was prepared by Elars Bioresearch Laboratories (Elars) for FAL in 1980 and 1981. Elars is an independent research organization specializing in safety and efficacy studies of drugs and vaccines for animal use. Very limited field testing of Pork Pardner by FAL took place during 1980. However, according to Elars, it would have cost a *minimum of* $1,000,000 to conduct *proper testing* and secure the government approvals necessary to market Pork Pardner. FAL received approximately $13,000 from Isle in 1980 and 1981 for testing and research. In the spring of 1981, because of the insufficiency of funds, Ms. Larson stopped work on Pork Pardner and began work on developing an external animal medication using an aloe extract. In 1982, such a product was developed and marketed by FAL.

No laboratory work or testing was ever carried out on the AloEase product. Mr. Marker traveled to the Caribbean in 1980 and secured 22,000 gallons of aloe extract. From time to time, he was reimbursed by Mr. White for his expenses, but in May 1981, he disassociated himself from ARL because Mr. White had not honored the contract for aloe extract negotiated by Mr. Marker, had not paid him for his services, and had not reimbursed him for money advanced by him in the pursuit of aloe extract.

On their income tax returns for 1979, the petitioners deducted the following amounts as their pro rata share of losses resulting from the programs:

Petitioners	AloEase	FAP
Mr. & Mrs. Drobny....	$ 7,990,	$19,998
Mr. & Mrs. Lifshitz...	15,980,	39,996

In the notices of deficiency, the Commissioner disallowed the claimed losses in full and determined that Mr. Drobny is liable for the addition to tax for fraud under section 6653(b) opinion

The case before the Court is representative of cases arising from two research and development programs. Except for the addition to tax for fraud sought against Mr. Drobny, all of the cases arising from these programs are factually identical, and the remaining docketed cases have agreed to be bound by the determination reached in this case.

The first issue for decision is whether the petitioners are entitled to deductions for their proportionate share of losses resulting from claimed research and experimental expenditures by AloEase and FAP for 1979. Section 174(a)(1) states, as a general rule, that "research or experimental expenditures which are paid or incurred by [a taxpayer] during the taxable year in connection with his trade or business," may, at the election of the taxpayer, be treated as expenses not chargeable to capital account and, therefore, may be deducted in the taxable year. The provisions of section 174(a)(1) "apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor)." Sec. 1.174 2(a)(2), Income Tax Regs.

A taxpayer need not currently be producing or selling any product in order to obtain a deduction for research and experimental expenditures. *Snow v. Commissioner*, 416 U.S. 500 (1974), rev'g. 482 F.2d 1029 (6th Cir.1973), aff'g. 58 T.C. 585 (1972). As we observed in *Green v. Commissioner*, 83 T.C. 667, 686, 687 (1984), "For section 174 to apply, the taxpayer must still be engaged in trade or business at some time, and we must still determine, through an examination of the facts of each case, whether the taxpayer's activities in connection with a product are sufficiently substantial and regular to constitute a trade or business for purposes of such section.," (Fn. ref. omitted; emphasis in original.)

It is well settled that to constitute a trade or business, the activity must be engaged in with an "actual and honest objective of making a profit." *Hirsch v. Commissioner*, 315 F.2d 731, 736 (9th Cir. 1963), aff'g. a Memorandum Opinion of this Court; *Green v. Commissioner*, 83 T.C. 667, 686 687 (1984); *Flowers v.*

Commissioner, 80 T.C. 914, 931 (1983); *Siegel v. Commissioner*, 78 T.C. 659, 699 (1982); *Dreicer v. Commissioner*, 78 T.C. 642, 646 (1982), aff'd. without opinion 702 F.2d 1205 (D.C. Cir. 1983); *Golanty v. Commissioner*, 72 T.C. 411, 425 (1979), aff'd. without published opinion 647 F.2d 170 (9th Cir. 1981); *Allen v. Commissioner*, 72 T.C. 28, 33 (1979); *Dunn v. Commissioner*, 70 T.C. 715, 720 (1978), aff'd. 615 F.2d 578 (2d Cir. 1980); *Churchman v. Commissioner*, 68 T.C. 696, 701 (1977); *Jasionowski v. Commissioner* (Dec. 33,828], 66 T.C. 312, 319 (1976); *Benz v. Commissioner* [Dec. 32,880), 63 T.C. 375, 383 (1974); *Bessenyey v. Commissioner*, 45 T.C. 261, 274 (1965), aff'd. 379 F.2d 252 (2d Cir. 1967). Although a reasonable expectation of profit is not required, the taxpayer must have the intent and objective of realizing a profit. *Hirsch v. Commissioner*, 315 F.2d at 736; *Brannen v. Commissioner*, 78 T.C. 471, 506 (1982), aff'd. 722 F.2d 695 (llth Cir. 1984); *Dreicer v. Commissioner*, 78 T.C. at 644, 645; § 1.183-2(a), Income Tax Regs. "Profit" in this context means economic profit, independent of tax savings. *Beck v. Commissioner*, 85 T.C. 557 (1985); *Herrick v. Commissioner*, 85 T.C. 237, 254 255 (1985); *Surloff v. Commissioner*, 81 T.C. 210, 233 (1983).

The issue of whether a taxpayer *engages in* an activity with the requisite intention of making a profit is one of fact to be resolved on the basis of all the facts and circumstances of the case. *Hirsch v. Commissioner*, 315 F.2d at 737; *Dreicer v. Commissioner*, 78 T.C. at 645; *Golanty v. Commissioner*, 72 T.C. at 426; *Allen v. Commissioner*, 72 T.C. at 34; *Dunn v. Commissioner*, 70 T.C. at 720. In making this determination, more weight must be given to the objective facts than to the taxpayer's mere after-the-fact statements of intent. Sec. 1.183-2 (a), Income Tax Regs.; *Thomas v. Commissioner*, 84 T.C. 1244, 1269 (1985), on appeal (4th Cir., Sept. 13, 1985); *Engdahl v. Commissioner* [Dec. 36,167), 72 T.C. 659, 666 (1979); *Churchman v. Commissioner*, 68 T.C. at 701. The petitioners bear the burden of proving that they possessed the required profit objective. Rule 142(a), Tax Court Rules of Practice and Procedure[4]; *see also Boyer v. Commissioner*, 69 T.C. 521, 537 (1977); *Johnson v. Commissioner*, 59 T.C. 791, 813 (1973), aff'd. 495 F.2d 1079 (6th Cir. 1974); *Sabelis v. Commissioner*, 37 T.C. 1058, 1062 (1962). The existence of the required profit objective is usually determined by the objective of the entity which has control over the activity under scrutiny. *Brannen v. Commissioner*, 78 T.C. at 504 505; *cf. Resnik v. Commissioner*, 66 T.C. 74, 80 - 82 (1976). Thus, the existence of a profit objective of a partnership is determined at the partnership level. *Rosenfeld v. Commissioner*, 82 T.C. 105, 112 (1984); *Brannen v. Commissioner*, 78 T.C. at 504, 505; *Goodwin v. Commissioner*, 75 T.C. 424, 434, 439 (1980). Such analysis is appropriate because each partner is really engaged in the business of his partnership and, therefore, it is the partnership which exercises control over the activity under scrutiny. *Brannen v. Commissioner*, 78 T.C. at 504 505, *Butler v. Commissioner*, 36 T.C. 1097, 1106 1107 (1961). For similar reasons, the existence of a profit objective of a joint venture is generally determined at the joint venture level. See *Brannen v. Commissioner*, 78 T.C. at 501, 505; *Madison Gas & Electric Co. v. Commissioner*, 72 T.C. 521, 557-565 (1979), aff'd. 633 F.2d 512 (7th Cir. 1980); *Grove v. Commissioner*, 54 T.C. 799, 801- 805 (1970).

Section 1.183-2(b), Income Tax Regs., sets forth some of the relevant factors, derived principally from prior case law, which are to be considered in determining whether an activity is engaged in for profit. *Boyer v. Commissioner*, 69 T.C. at 537; *Benz v. Commissioner*, 63 *T.C.* at 382, 383. Such factors include: (1) The manner in which the taxpayer carried on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the tax-payer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value;

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[4] Any reference to a Rule is to the Tax Court Rules of Practice and Procedure.

(5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profit, if any, which is earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved. *Allen v. Commissioner*, 72 T.C. at 33-34.

The petitioners contend that FAP and AloEase had the requisite profit objective because both operated with the bona fide purpose of developing and marketing aloe-based products.[5] In support of such contention, they argue that FAP and AloEase contracted for the research and development work to be performed by persons with experience in such activities and in whom they reasonably had confidence, and proper arrangements were made concerning the commercial exploitation of such products. However, after careful consideration of all the facts in this case, we conclude that the investment programs entered into by the petitioners were primarily intended to produce tax savings without any significant likelihood of an economic profit.

The investors were provided with very little information about the products to be developed. The offering memorandums for FAP and AloEase contained only a few paragraphs describing their products; by contrast, over 10 pages were devoted to describing the tax consequences of each program. A detailed tax opinion letter was prepared by the law firm, and no survey concerning the marketability of the products was performed, despite the known existence of established competition. Clearly, more resources were devoted to predicting tax consequences than marketing projections.

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[5] Mr. Lifshitz asserts that the question of profit objective should be stricken because it was raised by the Commissioner for the first time in his brief in answer. We disagree because such matter was raised in the notice of deficiency and addressed in Mr. Lifshitz's petition, his testimony at trial, and his opening brief. *Fox Chevrolet, Inc. v. Commissioner*, 76 T.C. 708, 733-736 (1981); *Estate of Horvath v. Commissioner*, 59 T.C. 551, 554-557 (1973); *Rubin v. Commissioner*, 56 T.C. 1155, 1162-1164 (1971), aff'd. per curiam 460 F.2d 1216 (2d Cir. 1972).

The programs were carried on in an unbusinesslike manner. While numerous documents were signed, not one was the product of arm's length negotiation. Indeed, Ms. Larson and Messrs. Marker and Swain, who signed many documents on behalf of ARL and FAL, were not permitted to read such documents and, - generally, executed them without any knowledge of their terms. As a result of such ignorance, Mr. Kamensky was able to create a paper trail of transactions for the proceeds of the bank loans, giving the appearance of a series of bona fide business transactions, without losing control over such proceeds. Such control was absolute; the bank provided him with the proceeds of the investors' loans without investor authorization and it purchased $900,000 of commercial paper in the name of ARL and FAL at his direction without the authorization of knowledge of Ms. Larson or Messrs. Marker and Swain.

Particularly disturbing is the lack of any coordinated management power on the part of the investors. Such deficiency was plainly stated in both memorandums along with a warning that it might lead to difficulties in enforcing contracts. Such intentional back of management clearly indicates that investors were not concerned with enforcing the terms of the various contracts involved in the programs and that the programs were not instituted with a profit objective. When that deficiency is combined with the absolute power held by Mr. Kamensky, the inference is compelling that the investors were simply purchasing tax benefits, and not interests in bona fide research and development programs.

The transactions between ARL and Isle were conducted in an unbusinesslike manner. A contract between the corporations was never signed, indicating that its terms were not important despite the contention that $320,000 was to be spent on AloEase product research. Without regard to the lack of a contract or any corporate assets for collateral, Isle made a $150,000 loan to ARL, without Mr. Marker's knowledge. The loan proceeds were used to make the option payment to AloEase, without Mr. Marker's knowledge, and no attempt has ever been made to collect upon such loan. We conclude that under the AloEase program, neither Isle nor ARL was intended to perform meaningful research and that the loan to ARL and the option payment to AloEase were simply a means of completing a series of paper transactions which were without substance and were designed to produce substantial tax benefits.

The transactions between FAL and Isle also were conducted in an unbusinesslike manner. The agreement between such corporations required FAL to develop Pork Pardner by September 15, 1981, while Isle had agreed with FAP to deliver such product on September 30, 1980. Discrepancies in both the day and year of product delivery, which made Isle's failure to perform very likely, would certainly have been detected by either of the two attorneys or Mr. Drobny if such terms were meaningful. That performance dates were not meaningful supports the conclusion that the purpose of the program was the production of tax benefits.

The acquisition agreement executed between Stoma and Ms. Larson provided the appearance of a bona fide business transaction but was totally unnecessary. Ms. Larson, under Mr. White's direction, was working on Pork Pardner in 1978 and 1979. In had not been patented, and there is no evidence that Stoma or anyone else was engaged in similar research. The fact that Stoma was promoted by Mr. Drobny adds support to our conclusion that such agreement is without substance and is indicative of a consistent pattern of deception surrounding the programs.

The individuals assigned the responsibility of performing the research did not have the expertise necessary to properly carry out such research. While Mr. White did have substantial relevant experience, he was not an active researcher for the programs. Ms. Larson was a former secretary and a supervisor, Mr. Marker was a retired pharmacist, and Mr. Swain was a salesman. Each of them had an interest in aloe-based products but did not have the training or history of successful product development that would reasonably warrant entrusting investors' money where there was no managing investors. In fact, Isle's large accumulated deficit indicates that Mr.

White's abilities were limited and his motive survival rather than new product development.

In sharp contrast with the individuals involved in research and development, exceptionally capable tax experts were actively involved in both programs. Messrs. Adler and Drobny were both former IRS employees who had become CPAs. Both had been instructors for the IRS and a CPA review course. Additionally, they specialized in tax matters. Mr. Kamensky had structured similar tax shelter transactions and was known in Chicago as an attorney with experience in the formation of research and development tax shelters. The tax personnel were clearly far superior to the research and development staff, supporting an inference that the tax consequences were the primary objective of the programs.

Most significant is the fact that very little money was actually spent on research and development work. After the circular flow of the $900,000 proceeds of the bank loans, the investors supplied only $220,000 of actual cash for the programs. After the payment of fees to the law firm and the accounting firm, only $145,000 was available for research and development. Such amount is substantially less than the $1,000,000 necessary to gain the required government approvals for Pork Pardner, indicating that there was no genuine intent to develop the product.

The transactions surrounding the circular flow of the $900,000 proceeds of the bank loans had no substance for tax purposes. The $800,000 payment to Isle by FAP, the $750,000 payment by Isle to FAL, and the $750,000 royalty payment from FAL to FAP constituted nothing more than a circular series of transactions. Similarly, the $320,000 payment to Isle by AloEase, the loan from Isle to ARL of $150,000, and the payment by ARL to AloEase of $150,000 were circular transactions. The transactions took place on paper only, were carried out in one day, and had the effect of increasing, for tax purposes only, the cost of services purchased from Isle to five times the actual cost; no part of the $900,000 was used for research and development.

The investors were practically guaranteed that the proceeds of the bank loans would be available to satisfy such loans. The control retained by Mr. Kamensky over the proceeds insured that the investors would not have any out-of-pocket expense for the loan principal. The bank loans totaling $900,000 were followed immediately by a series of paper transactions and by the purchase of commercial paper for such amount at the bank. The commercial paper came due on January 14, 1980, and the proceeds were immediately distributed to the investors, so that they were available to satisfy the bank loans which came due on January 16, 1980. The funds never left the bank; indeed, in December 1979, the bank had post-dated checks from each investor in the amount of his loan and interest. The petitioners argue that because the commercial paper was purchased in the name of ARL and FAL, either entity could have prevented the investors from receiving such funds. This argument is merit less because both corporations were controlled by Mr. Kamensky, either directly or through Mr. White, and Ms. Larson and Messrs. Marker and Swain had no knowledge of the underlying transactions or the existence of the commercial paper; while in theory such interference might have occurred, it was realistically impossible. Therefore, we conclude that the transactions that resulted in the circular flow of the $900,000 proceeds of the bank loans were shams entered into solely to create the illusion of research and experimental expenditures, while in substance insuring that no part of such funds would be so used. *Cf. Karme v. Commissioner*, 73 T.C. 1163, 1185 1195 (1980), aff'd. 673 F.2d 1062 (9th Cir. 1982); *Bridges v. commissioner*, 39 T.C. 1064, 1076, 1077 (1963), aff'd. 325 F.2d 180 (4th Cir. 1963). In the unlikely event that a product was developed, the intricate network of agreements engineered by Mr. Kamensky insured that any profits to AloEase or FAP would be minimal. Under the exclusive license agreement between FAL and FAP, the investors received no royalties beyond the $750,000 advanced minimum royalty until sales reached $3,000,000. FAP was to receive a license fee of 25 percent of gross sales up to $3,000,000, with such license fee to be offset against the advanced minimum royalty. For sales of $3,000,000 or more, FAP was to receive a 12-percent fee. At the same time, for sales over $3,000,000, FAP was to pay Ms. Larson a 6-percent fee. Because the advanced minimum royalty was merely a means of achieving a circular flow of $750,000 of the proceeds of the bank loans, the investors could not receive an economic return on their investment in Pork Pardner until sales reached $3,000,000, and then the net would only be 6 percent of gross sales. Such a return, where the product research is severely under funded, thereby making product development unlikely, is so small as to allow the inference that there was no profit objective. ARL paid $150,000 for the option agreement with AloEase; such transaction was merely a circular flow of the proceeds of the bank loans and did not represent an economic return on investment. To exercise the option, ARL had to pay an additional $300,000. If the option was not exercised, there could be no marketing or sales of the AloEase product for 10 years. The exercise of such option was highly unlikely because ARL was a new corporation created solely for the AloEase program with no assets and a $150,000 debt to Isle. it had no written contract with Isle and had no prospects of ever earning or borrowing $300,000.

Finally, the absence of any marketing projections or estimates of revenue from goods sold is one further indication that the programs had no profit objective. As the petitioners properly point out, sales estimates for new products may not be very reliable. However, the absence of any effort to ascertain whether the investors would receive a return on their $220,000 investment indicates they were purchasing tax benefits. The petitioners point to Ms. Larson's activities in developing an external animal medication and Mr. Marker's search for a source of aloe extract as indicators that the projects had a profit objective. However, these activities were not caused by changed circumstances and, therefore, could have been described in the placement memorandums. Yet, the activities are not described in the memorandums, and we are convinced that they were in no way contemplated by the investors or the promoters.

Rather, they arose from the interest of Ms. Larson and Messrs. Marker and White in aloe based medications in general and as such do not reflect on the two programs or the investors.

Mr. Drobny's testimony that as of 1984 he had actually lost $425, including tax savings, as a result of investing in the programs does not indicate a profit objective. We observe that such claim is not substantiated and that such a loss would not be relevant to his motive in 1979 because it is a small dollar amount and is remote in time. Mr. Lifshitz's assertion that he expected a cash flow from the programs in excess of 8 percent is also not persuasive. In the late 1970's the aloe vera based product market was expanding; however, given the structure of these programs, such an expectation would have been pure fantasy. The self-serving nature of such claim, combined with the absence of any evidence in support, renders it implausible.

Because we find for the Commissioner on the profit objective issue, we do not address the alternative positions advanced by him.

The second issue for decision is whether Mr. Drobny is liable for the addition to tax for fraud under section 6653(b) for 1979. Such section provides that if any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to such tax an amount equal to 50 percent of the underpayment. The Commissioner has the burden of proving, by clear and convincing evidence, that some part of the underpayment for such year was due to fraud. Sec. 7454(a); Rule 142(b); *Levinson v. United States*, 496 F.2d 651 (3d Cir. 1974); *Otsuki v. Commissioner*, 53 T.C. 96, 105 (1969). To establish fraud, the Commissioner must show that the petitioner intended to evade taxes which he knew or believed that he owed, by conduct intended to conceal, mislead, or otherwise prevent the collection of such taxes. ***Webb** v. Commissioner*, 394 F.2d 366, 377 378 (5th Cir. 1968), aff'g. a Memorandum Opinion of this Court; *Powell v. Granquist*, 252 F.2d 56, 60 (9th Cir. 1958); *Acker v. Commissioner*, 26 T.C. 107, 111, 112 (1956). It is well settled that a fraudulent understatement of income can be accomplished by means of an overstatement of deductions. *Hicks Co. v. Commissioner*, 56 T.C. 982, 1019 (1971), aff'd. 470 F.2d 87 (lst Cir. 1972); *Neaderland v. commissioner*, 52 T.C. 532, 540 (1969), aff'd. 424 F.2d 639 (2d Cir. 1970).

The presence or absence of fraud is a factual question to be determined by an examination of the entire record. *Gajewski v. Commissioner*, 67 T.C. 181, 199 (1976), aff'd. without published opinion 578 F.2d 1383 (8th Cir. 1978). Fraud will never be presumed. *Beaver v. Commissioner*, 55 T.C. 85, 92 (1970). However, fraud may be proved by circumstantial evidence since direct proof of the petitioner's intent is rarely available. His entire course of conduct can often be relied on to establish the requisite fraudulent intent. *Stone v. Commissioner*, 56 T.C. 213, 223, 224 (1971); *Otsuki v. Commissioner*, 53 T.C. at 195-106 [sic]. When a claim of ignorance or honest mistake is set forth, this Court must consider the petitioner's intelligence, education, and tax expertise in making its determination. *Iley v. Commissioner*, 19 T.C. 631, 635 (1952).[6]

We have already held that the deductions claimed by Mr. Drobny for losses attributable to FAP and AloEase were not allowable, and the claiming of such deductions resulted in an underpayment of his tax for 1979. Therefore, the only remaining inquiry concerns the willfulness of his acts. The evidence convincingly establishes that he fraudulently underpaid his taxes for the year 1979.

There is considerable evidence to show Mr. Drobny's fraud. He is an intelligent and educated man, who is an experienced tax specialist. He was aware of all the transactions which constituted the FAP and AloEase programs. The letter from the law firm dated November 28, 1979, set forth the financial *aspects of the*

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[6] *See Toussaint v. Commissioner*, T. C. Memo. 1984-25, aff'd. 743 F.2d 309 (5th Cir. 1984); *Green v. Commissioner*, T. C. Memo 1981-577; *Schwartz v. Commissioner*, T. C. Memo. 1974-245; *Langlois v. Commissioner*, T.C. Memo. 1955-56.

programs including: flow charts, descriptions of the transactions, a tax benefit analysis, and a cash flow analysis. The placement memorandums concerning the programs described important elements of such programs.

Mr. Drobny was aware of the law regarding taxes, in general, and research and experimental expenditure deductions, in particular. His knowledge as a tax specialist was supplemented by information appearing in the tax opinion letters. Such letters state that substance over form controls tax liability and that the form of a transaction may be disregarded if it has no purpose other than reduction of taxes. The lack of arm's length transactions is identified as frequently giving rise to the use of the substance-over-form rule to disregard the form of the transaction. Finally, the law firm points out that if it cannot be shown that the amount paid to Isle is approximately equal to the value of services rendered, such amounts might not be deductible.

With the information available to him and with his understanding of such affairs, Mr. Drobny knew that very little of the money could in fact be used for research work. Under the two programs, total deductions of $1,120,000 were claimed, but the $900,000 borrowed from the bank was repaid within a month. Of the total, not more that $220,000 was available for research, but in fact, $75,000 was paid as legal fees and accounting fees. Thus, only $145,000 could be spent for research. Some of the investors may not have understood these facts, but the conclusion is inescapable that Mr. Drobny knew that the funds for which he claimed deductions would not in fact be used for research. In his case, he purchased only a one-half unit; thus, he put up $5,500 and claimed a deduction of $27,988; yet, he knew that most of that amount could not be used for research purposes.

Mr. Drobny argues that he reasonably believed the deductions were legitimate. In support of such contention, he says that he reasonably relied on the expertise of the law firm and the fact that similar programs structured by Mr. Kamensky had not been challenged by the Commissioner. Mr. Drobny is a tax expert and promoter of considerable experience. He was aware that the law firm was receiving $35,000 for its efforts in support of the programs and, therefore, had an interest in securing a positive investor response. Mr. Drobny knew of those circumstances, and with that knowledge and his sophistication, he cannot claim to have relied upon the expertise of the law firm. Indeed, the placement memorandums state in a capital letters that investors should seek independent counsel concerning the tax consequences of the programs. Finally, we do not believe that a person of Mr. Drobny's experience, including 4 years at the IRS, could reasonably have relied upon lack of action by the Commissioner as a basis for determining the legitimacy of the programs when he had detailed knowledge of the use of the proceeds of the bank loans.

Mr. Drobny states that based on past business experience with Isle and Mr. White, he reasonably believed that the contracts would be completed. Such contention is not believable because he knew that the research and development activities had been subcontracted to ARL and FAL, neither of which had a financial existence apart from the programs, and that only $145,000 would be available for such activities. Additionally, product development would not have changed the tax consequences of the circular flow of the loan proceeds and would very likely not have produced an economic profit to the investors.

Also, Mr. Drobny contends that he did not prepare any of the documents or financial data that were used in the programs and, therefore, did not commit fraud. The preparation of such documents is not required to prove fraud; knowing participation is sufficient.

We conclude that this evidence, taken as a whole, clearly and convincingly indicates that Mr. Drobny knew that some or all of the research and experimental expenditures arising from the programs were not deductible and that he intentionally reported losses resulting from such claimed deductions on his 1979 income tax return, resulting in a fraudulent underpayment of tax.

Decisions will be entered for the respondent.

Interview/Reviewed:

Revenue Agent Irving FEINGLASS

By: Inspectors Peter McCauley & John Corcoran
On: January 18, 1985
At: Chicago, Illinois

On January 18, 1985 Inspectors PETER McCAULEY and JOHN CORCORAN interviewed Revenue Agent IRVING FEINGLASS at the Inspection Office, 35 E. Wacker Drive, Chicago, Illinois. During the interview Revenue Agent FEINGLASS was accompanied by N.T.E.U. representative CHARLES TUREK. TUREK is employed as a Revenue Agent with the Internal Revenue Service in Chicago, Illinois. Revenue Agent FEINGLASS is employed at the Chicago, Illinois District, is a GS-13. and has been employed by the I.R.S. for thirteen years. Inspector CORCORAN read to Revenue Agent FEINGLASS Notice 417, Privacy Act Notice and Form 8111, Employee Notification Regarding Union Representation and had him sign Form 8111. Revenue Agent FEINGLASS was then placed under oath. The nature of the interview was to discuss his dealings with RANDALL GOULDING, the tax shelters GOULDING created, and his discussions with other individuals involved in the tax shelters. Revenue Agent FEINGLASS stated that he has known RANDALL GOULDING for approximately two years in his capacity as a Revenue Agent. He first came in contact with him during an audit **(blacked out).** He does not have any social or other relationships with GOULDING. FEINGLASS stated he knew **(blacked out).** He has never met **(blacked out)** but has talked to him on the telephone on several occasions. He first spoke with **(blacked out)** to inform him that he could deduct 50% of cash out of pocket which was invested in **(blacked out)** and not the 100% he wanted. When asked, FEINGLASS denied saying they should hang GOULDING by his feet or "If I were you I would shoot him" (Goulding) to **(blacked out)** and termed the second allegation ludicrous. FEINGLASS said he knows STEVE NAGLER and that NAGLER is an attorney and represented **(blacked out)** who was an investor in **(blacked out).** He believes NAGLER was hired by **(blacked out)** to decide whether **(blacked out)** should accept the 50% of cash out of pocket deduction the I.R.S. had offered regarding this investment in that tax shelter. He could recall meeting with NAGLER twice and may have had telephone conversations with him. He denied saying to NAGLER that the audit of **(blacked out)** resulted from an "Investigation on RANDY GOULDING and his deals and that was the sole reason for the audit." FEINGLASS characterized this as a mis-quote.

FEINGLASS stated he has not had any dealings with **(blacked out)** and could only recall meeting him once while he was interviewing (**blacked out**) who was an investor in **(blacked out).** He does not recall telling **(blacked out)** that **(blacked out)** was audited " As a result of Randy Goulding's activities". Revenue Agent FEINGLASS did state that he told FRED BRODIE who was **(blacked out)** attorney that **(blacked out)** was being audited and investors contacted because as a tax shelter it was found to be lacking.

By: John W. Corcoran
By: A. Stone
Date Dictated: January 18, 1985
Date Transcribed: January 28, 1985
Case #: 3-1184-0037

Inspector CORCORAN asked Revenue Agent FEINGLASS if he ever told an attorney that the audit of his client was a result of the audit of **(blacked out)** a taxpayer GOULDING represents. .

Revenue Agent FEINGLASS replied **(blacked out)** was determined to be an abusive tax shelter and as a result the Investors were being audited. He further stated that if a taxpayer asks why they are being audited he has an obligation to tell them. Therefore when someone who was being audited as a result of investing in **(blacked out)** he would tell them that was the reason.

Inspector CORCORAN then asked Revenue Agent FEINGLASS if he ever approached a client of Mr. GOULDING'S just before trial and stated "If I were you, I would not have GOULDING representing me". He replied that he did not say that but did relate a situation involving a tax shelter based on investments research and development of products that contained extracts from the Aloe Vera plant. Prior to the trial Revenue Agent FEINGLASS told one of the investors, **(blacked out),** that the I.R.S. would accept a cash settlement from him but only if he supplied the I.R.S. with information and discharged RANDALL GOULDING as his attorney. This was done per the instructions of I.R.S. legal council, LOREN GORE and BILL SABIN. Revenue Agent FEINGLASS believed this occurred sometime in September or October 1984. The offer was declined.

In general, Revenue Agent FEINGLASS characterized the statements attributed to him as mis-quotes or quotes out of context. He concluded by saying he has no animosity or any other feelings towards Mr .GOULDING and that he has conducted himself in a business like manner in any dealings he has had with him.

ADLER DROBNY FISCHER, LTD.
Certified Public Accountants & Consultants

May 27, 1994

The Honorable Justice Walter J. Cummings
U.S. Court of Appeals
Seventh Circuit
219 South Dearborn Street
Suite 2702
Chicago, Illinois 60604

RE: *United States v. Goulding*

Dear Judge Cummings:

On May 25, 1994, your panel affirmed the conviction of Mr. Goulding on all counts. I direct you to page 9 of your decision:

> ... In the end, Goulding's claims rest on little more than the fact that the criminal investigation was started sometime after he brought suit against the IRS agents and only meager evidence that those agents disliked him. Given the flimsiness of his claims, the district court was completely within its authority when it denied Goulding's motion to dismiss the prosecution. (emphasis added)

As a result of several years of persistence on my part and the honesty of IRS attorney Robert Ratchford in the matter of *Drobny v. Commissioner,* a Tax Court case in which Mr. Goulding represented several petitioners, we have uncovered conclusive proof that Mr. Feinglass at the direction of IRS attorneys Sabin and Gore did in fact make unethical and illegal contact with one of Mr. Goulding's clients. I have enclosed for your information the documents submitted to the

Tax Court by Mr. Ratchford which substantiates this allegation.

ADLER/DROBNY/FISCHER The Honorable Justice
Certified Public Accounts & Consultants Walter J. Cummings
May 27, 1994

These documents were suppressed by the IRS in Mr. Goulding's civil rights action against Mr. Feinglass. As a result of the aforementioned, the Regional Inspector Midwest Region in conjunction with the Treasury Department Inspector General are conducting an internal investigation of the matter which may have far reaching implications to Mr. Goulding.

I urge you to carefully review this material since it is the first conclusive evidence that there was serious IRS misconduct concerning the prosecution of Mr. Goulding. There are many other innocent victims of this behavior perpetrated by these IRS personnel. I am sure that you will agree that this new information is neither meager or flimsy and represents but the "tip of the iceberg" of this IRS misconduct

Very truly yours,

Sheldon Drobny

SD.-jdg
Enclosure
cc: Honorable Justice Rovner
Honorable Justice Kanne

UNITED STATES COURT OF APPEALS
SEVENTH CIRCUIT

CHAMBERS OF
WALTER J. CUMMINGS
CIRCUIT JUDGE

219 SOUTH DEARBORN STREET
CHICAGO. ILLINOIS 60604

May 31, 1994

Mr. Sheldon Drobny
Adler Drobny Fischer, Ltd.
95 Revere Drive - Suite A
Northbrook, Illinois 60062-1585

Re: United States v. Goulding

Dear Mr. Drobny:

Thank you for your helpful letter of May 27, together with its attachments. You may be sure that this material will be considered by the panel.

Sincerely,

Walter J. Cummings
CC: Honorable Michael S. Kanne
Honorable Ilana Diamond Rovner

Appendix G - App. 89

Excerpt of Oral Arguments - June 5, 1996, 9:30 am, Room 2721

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Judge: Could you explain a little bit to me about the communication between the commissioner or the IRS and the Tax Court which all these cases got pushed into one sort of speeded-up calendar.

Janet Bradley: Well, it's my understanding some of this is in the record and some of this has been informally relayed to me. It's my understanding, again, that back in the 80's that there was just a lot of tax shelter cases that were arising out of the Chicago area office and it's my understanding also that many of the tax court judges that ride circuits to various jurisdictions to try cases. Apparently Judge Simpson was or either had family members or whatnot liked to come to the Chicago area and apparently at that time Harmon Dow who was then the assistant district counsel seeing these 2,500 or so odd tax shelter cases in the office needed to come up with some way to adjudicate these in a reasonable and speedy fashion. So apparently, seeing this tremendous influx, thought it would be a prudent course of action to actually pick up the telephone and contact the judge to let them know that this many cases were coming.

The way the Tax Court had been handling matters in the past wouldn't be an efficient method, in his mind, for dealing with this volume of cases. There was legislation, at the time, where Congress, and we cited in our brief, was directing the Tax Court and IRS to come up with some coordinated method to handle this volume - this backlog just to get them efficiently dealt with in the Tax Court. And apparently, Judge Simpson asked Harmon Dow to then fax a list of the cases. So included amongst this list of 2,500 cases, we understand, was the Drobnys' case. There's no indication in the record whatsoever that this case was ever mentioned, discussed or anything other than being included on this list, this computerized fax list of well over 2,500 cases, and that was faxed to the Tax Court. So there's no indication whatsoever that prior to the time this case was set for hearing that this case was mentioned.

Judge: The same person that called Judge Simpson was also the one that prosecuted this case?

Janet Bradley: No, not all the way through. No.

Judge: Initially, started with it?

Janet Bradley: Initially, but basically overseeing probably all 2,500 cases. ***I'm sure*** it's like in my office who the chief of my section oversees every case and his name is on every brief that is filed in the court but ***he has no idea of the facts of the large volume of cases there*** - it's basically the ***lower line attorneys, like myself, who are the ones that actually write the briefs, argue the cases, and deal with the other side in the courts in handling the matters***. So that was the status of what happened there. There was no allegation of anything more than that and ***there was no evidence whatsoever of anything more than that***.

Judge: That's all, thank you.

Janet Bradley: Thank you.

Judge: This court will take this case under advisement and proceed to case number 2 please.